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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1927. No. 228.

NATIONAL LIFE INSURANCE CO., - Petitioner,

vs.

THE UNITED STATES.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR PETITIONER.

The Revenue Act of 1921 is void, in so far as it provides that a tax-payer owning tax-exempt securities shall be deprived (to the exact extent of the tax-exempt income therefrom), of deductions allowed other tax-payers, who do not hold tax-exempt securities.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1927. No. 228.

NATIONAL LIFE INSURANCE CO., - *Petitioner,*

vs. [Oral Argument April 12, 1928.]

THE UNITED STATES.

On Writ of Certiorari to the Court of Claims.

BRIEF FOR THE NATIONAL LIFE INSURANCE CO.

[References required by Rule 25]

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(1) The opinion below (*National Life Ins. Co.* v. *U. S.*, 63 Ct. Cls. 256; R. 17), and the judgment thereon, were both rendered March 7, 1927 (R. 25), dismissing the National Life's suit to recover $92,495.29 income taxes for 1921, claimed to have been illegally collected upon $924,901.99 tax-exempt income derived solely from State and Federal *tax-exempt* bonds (R. 8-12; 14-16).

(2) The jurisdiction of this Court was invoked by a writ of *certiorari*, granted June 6, 1927, to review the above cause (274 U. S. 734, R. 25; Act. Feb. 13, 1925, c. 229, §3, 43 Stat. 939; U. S. C. Title 28, §288).

THE QUESTION INVOLVED.

The only* question involved is whether the Treasury Department's very ingenious device for *depriving* life insurance companies of the *exemption* on tax free bonds is constitutionally permissible? *i. e.*, Can Congress, *first*, allow an exemption as to income from tax-free bonds, and then, *secondly*, simultaneously exact *as an additional tax*, the *precise amount* of the exemption, *for the sole reason* that the taxpayer has received such an exemption?

Stated in algebraic form, Congress defined a life insurance company's net income, on which a 10% income tax was levied, as follows (Revenue Act of 1921, §245 (a) (2); 42 Stat. 261):

(1) Net Income = Gross Income — Tax-exempt income— [4% of Reserve — Tax exempt Income]**

Clearing the bracket, we have,

(2) Net Income = Gross Income — Tax-exempt income— 4% of Reserve + Tax exempt Income

---

*No question of fact, or of statutory interpretation, or retroactivity is presented.

**The Statute also allows certain other miscellaneous items of deduction, such as investment expenses, real estate taxes, depreciation, interest, etc., about which no question arises (Revenue Act of 1921, §245 (a) sub-divisions (3), (4), (5), (6), (7), (8), (9); 42 Stat. 261-2).

For brevity, these undisputed deductions will not generally be referred to; or, if referred to, will be collectively designated as "Miscellaneous Deductions."

Cancelling the respective + and — items of "Tax Exempt Income" against each other, it leaves

(3) Net Income = Gross Income — 4% of Reserve.

The result is that *all* tax-*exempt* income, being first included in the "Gross Income," is finally *included in the taxable net income;* so that the *entire tax* collected from the National Life for 1921 ($92,495.29) was *solely* on account of $924,901.99 income from tax-free State, Municipal and Liberty bonds.

THE RELEVANT STATUTES.

The Revenue Act of 1921 provided (42 Stat. 237, 252, 261):

> "Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term '*gross income*' • • •
>
> "(b) *Does not include* the following items, which shall be exempt from taxation under this title: • • •
>
> "(4) *Interest upon* (a) the *obligations of a State*, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the *obligations of the United States* or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent

it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes; • • •

"Section 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

"(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; • • •

TAXES ON INSURANCE COMPANIES.

"Sec. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

"(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230; • • •

"Sec. 244. (a) That in the case of a life insurance company the term '*gross income*' means the gross amount of income received during the taxable year from *interest, dividends,* and *rents.* • • •

"Sec. 245. (a) That in the case of a life insurance company the term '*net income*' means the gross income *less*—

"(1) That amount of *interest* received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

"(2) An amount equal to the *excess,* if any, *over the deduction* specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year. • • •

[Here follows seven further deductions number (3).....(9) not in controversy.]

STATEMENT OF THE CASE.

1. *The National Life's fiscal situation.* So far as material here, the National Life's fiscal situation for 1921 was as follows:

Gross Income (R. 15)		
(a) Interest	$3,811,132.78	
(b) Dividends	0.00	
(c) Rents	13,460.00	$3,824,592.78
Including:		
Tax-exempt Income (R. 15)		
(d) From State bonds	$873,075.66	
(e) From Liberty bonds	252,712.60	$1,125,788.26
Gross income constitutionally subject to taxation (R. 8)		$2,698,804.52
Authorized Deductions under Revenue Act of 1921:		
4% of $67,381,977.92 Reserve (R. 15)		$2,695,279.12
Miscellaneous Deductions (R. 15)		204,411.67
Authorized Deductions		$2,899,690.79
Income subject to taxation		2,698,804.52

As the authorized deductions ($2,899,690.79) were actually *more* than the total gross income constitutionally subject to taxation ($2,698,804.52), the National Life insisted that it did not owe any income tax at all.

After payment under protest and the necessary preliminary steps (R. 13-17) the National Life brought this suit to recover the $92,490.20 tax, upon the ground that the Act under which the tax was collected was unconstitutional because it taxed tax-exempt income (R. 8-12).

2. *The Revenue Act of 1921.* The Act specifically defined a life insurance company's "*Gross* Income" as its "Interest, Dividends and Rents" [42 Stat. 261; §244 (a)]; and provided that, for 1921, it should pay an income tax of 10% of its "*Net* Income" [Cf. §§230 (a), 243 (1)].

It then defined such "*Net* Income," to be the "*Gross* Income," less *nine* specific deductions, numbered (1) (2) (3) . . . (9).*

This controversy turns on deductions (1) and (2) which are (1) tax-exempt income, and (2) [4% of Reserve *minus* (1)], as thus expressed in §245 (a):

> "Sec. 245 (a) That in the case of a life insurance company the term 'net income' means the gross income less—
>
> "(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;
>
> "(2) An amount equal to the *excess*, if any, *over* the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, • • •"

After the Treasury tax adviser, Dr. Adams, had covered six fine print pages of colloquy in trying to explain to the Senate Finance Committee that §245 (a) was devised in such involved language "in order *not* to give them [life insur-

*As no question arises about the *last seven* deductions, *i. e.*, (3) . . . (9), which amounted to $204,411.67, they will be disregarded, or referred to collectively as "Miscellaneous Deductions." (See p. 2, note, *supra*.)

CORRECTION.

leference to a suggestion from the Solicitor General's office, we olify the quotations given in our Brief, pp. 6-7, from the "Con- Print" as follows:

er quoting from §245(a)(1)(2), Dr. ADAMS said (p. 86; R. 7):

"This was devised in order *not* to give them [life insurance com- s] exemption from tax-exempt bonds. The theory of the tax *not justify* any real exemption from tax-exempt income. They ake it out in that way and then the other deductions that they l ordinarily get is reduced by that amount."

ADAMS then reread §245(a)(2) and endeavored to "explain" ning.

NATOR McCUMBER then said (p. 86):

SENATOR McCUMBER: "I can not imagine anything more abstract nmeaning to the average intellect in reading that paragraph the t is written." [Followed by further criticisms of the same kind.]

ADAMS then went over the subject again with SENATOR McCUM- o finally said (p. 88).

SENATOR McCUMBER: "I am much obliged, Doctor. I understand ost as well as I did before you made your explanation. But I ne somebody will understand it. I confess that I do not."

ance companies] exemption from tax-exempt bonds." Senator McCumber said with delicious irony:

> "Senator McCumber: I am much obliged Doctor. I understand it *almost as well* as I did *before* you made your explanation. But I assume somebody will understand it. I confess that I don't. * * * I can not imagine anything more abstract and unmeaning to the average intellect in reading that paragraph the way it is written." (Confidential Print for use of Members of the Senate; Hearings before Senate Finance Committee 67 Cong. 1st Sess. on H. R. 8245, p. 88.)

As the "Confidential Print" (pp. 83-88) reveals, it is extremely difficult to grasp the real effect of §245 (a) from the printed page alone; but expressed algebraically, its meaning and effect as applied to the National Life are instantly seen, as follows (omitting the cents for typographical brevity):

[$3,824,592] [$3,811,132] [$0] [$13,460]
(1) Gross Income = Interest + Dividends + Rents

[$3,824,592] [$1,125,788]
(2) Net Income = Gross Income — Tax-exempt Income —

[$2,695,279] [$1,125,788] [$204,411]
[4% of Reserve — Tax-exempt Income] — Misc. Deductions

Clearing brackets, we have

[$3,824,592] [$1,125,788]
(3) Net Income = Gross Income — Tax-exempt Income —

[$2,695,279] [$1,125,788] [$204,411]
4% of Reserve + Tax-exempt Income — Misc. Deductions

Cancelling the identic + and — items of

[$1,125,788]
Tax-exempt Income, we have

(4) Net Income = Gross Income [$3,824,592] − 4% of Reserve [$2,695,279] − Misc. Deductions. [$204,411]

(5) Net Income = $3,824,592 − $2,695,279 − $204,411
= $3,824,592 − $2,899,690 = $924,902.00

10% of Net Income as per §230, 243(1) = 92,490.20
Interest 5.09

1921 Tax in controversy (R. 15) $92,495.29

Equation (4) shows that the effect of the statute is to include *all tax-exempt income* in the "net income" on which the 10% tax is levied.

Although the National Life derived *nearly one-third* of its entire gross income from tax-*exempt* securities, yet it had to pay exactly the *same tax* as it would have paid if its *whole* income were from *taxable* securities (see p. 10, *infra*). As aptly said by McREYNOLDS, J., in *Nichols* v. *Coolidge*, 274 U. S. 531, 541, "Taxes are very real things and statutes imposing them are estimated by practical results."

3. *The effect of the Act.* It accomplished Dr. Adams' declared intention of *not* giving to the tax-payer any exemption on his tax-exempt bonds, by the simple expedient of first allowing the exemption, and then providing that any tax-payer, having such exemption, should have his *authorized deductions, ipso facto* reduced by the exact amount of his tax-exemptions. Or, as Dr. Adams aptly and frankly said (Confidential print p. 86):

> "The theory of the tax *does not justify and real exemption* from tax-exempt income.

> They first take it out in that way and then the other deductions that they would ordinarily get is reduced by that amount."

(1) It is for this Court now to say (a) whether Congress under the guidance of a Treasury "expert," can constitutionally determine that an income tax "*does not justify* any real exemption from tax-exempt income," and (b) whether this Court's repeated declarations* that the means and instrumentalities of the State and Federal Governments are respectively exempted from taxation by the other, are constitutionally paramount, and really mean what they say, and can not be evaded by a bold and transparent device, because Congress thinks such exemption is not "justified" from an income tax.

(2) The essential vice of the Act is shown by comparing, in parallel columns, its effect on two life insurance companies, A and B, identical in every respect, except that A has $25,000,000 invested in 4% State bonds, and B has $25,000,000 in 4% Railroad bonds.

Pollock v. *Farmers Loan & Trust Co.*, 157 U. S. 429, 584, 158 U. S. 601, 630; *Mercantile Bank* v. *New York*, 121 U. S. 138, 162; *Collector* v. *Day*, 11 Wall. 113, 124; *U. S.* v. *Railroad Co.*, 17 Wall. 322; *Weston* v. *City of Charleston*, 2 Pet. 449; *Bank* v. *Supervisors*, 7 Wall. 26; ***Farmers Bank*** v. *Minn.*, 232 U. S. 516; *Van Brocklin* v. *Tenn.*, 117 U. S. 151; *Choctaw & Gulf R.* v. *Harrison*, 235 U. S. 292; *Dobbins* v. *Commissioners*, 16 Pet. 435; *McCulloch* v. *Maryland*, 4 Wheat. 316; *Williams* v. *Talladega*, 226 U. S. 404, 418, 419; *California* v. *Pacific R. R. Co.*, 127 U. S. 1; *Owensboro Nat. Bank* v. *Owensboro*, 173 U. S. 664; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 521-524.

	Company A		Company B	
Assets	$115,000,000			$115,000,000
Reserve	100,000,000			100,000,000
4% of Reserve	4,000,000			4,000,000
Gross Income	5,600,000			$5,600,000
Made up as follows:				
State bonds	$1,000,000		State bonds	00
R. R. bonds	00		R. R. bonds	$1,000,000
Interest, &c.	4,600,000		Interest, &c.	4,600,000
	$5,600,000			$5,600,000
Misc. Deductions		500,000		500,000

COMPUTATION OF NET INCOME UNDER REVENUE ACT OF 1921.

	Company A		Company B	
Gross Income	$5,600,000			$5,600,000
Deduct				
Tax-exempt Income	1,000,000			0
	$4,600,000			$5,600,000
Deduct			*Deduct*	
4% Reserve	$4,000,000		4% Reserve	$4,000,000
Tax-exempt	1,000,000	$3,000,000	Tax-exempt	00 $4,000,000
	$1,600,000			$1,600,000
Misc. Deductions	500,000			500,000
Taxable Income	$1,100,000			$1,100,000
10% Tax	$110,000			$110,000

The companies A and B pay precisely the same tax, to wit: $110,000 each, although A has $1,000,000 income from tax-*exempt* bonds, while B's corresponding $1,000,000 income is from Railroad bonds.

The Act absolutely deprives A of any benefit (*i. e.*, tax-exemption) from owning $25,000,000 tax-exempt bonds, and the Act thereby taxes the instrumentalities of the States exactly as it does those of ordinary railroad corporations.

Another illustration may be useful:

	Company A			Company B	
Gross Income		$5,000,000			$4,000,000
Tax-exempt Income	$1,000,000				00
4% Reserve	$4,000,000		$4,000,000		
Tax-exempt	1,000,000	3,000,000	000	$4,000,000	$4,000,000
Deduction		4,000,000	$4,000,000		
Taxable Income		$1,000,000			00
10% Tax		$100,000	10% Tax		00

Although both A and B have exactly the *same income* that is *constitutionally* subject to taxation, to wit: $4,000,000, yet A pays $100,000 income tax, to wit: 10% on the $1,000,000 tax-exempt income from State bonds; while B pays *nothing at all.*

Let us take two cases where the income, that is *constitutionally* subject to taxation, is exactly the same, to wit: $2,810,000; and yet under §245(a)(2) one company is taxed *twelve times as much as the other, solely* because it is unfortunate (?) enough to have owned U. S. bonds producing $1,000,000 income.

Company A			Company B	
Gross Income		$3,810,000	Gross Income	$2,810,000
Deductions—				
(1) Tax free income	$1,000,000		(1) Tax-free Income	0
(2) Excess of 4% of Reserves over (1) [$2,720,000—$1,000,000]	$1,720,000	2,720,000	(2) Excess of 4% of Reserves over (1) [$2,720,000 . . . . . 0]	2,720,000
Taxable Income		$1,090,000	Taxable Income	$90,000
10% Tax		$109,000	10% Tax	$9,000

Company A with a Gross Income of $3,810,000, including $1,000,000 tax-free income, has only $2,810,000 income subject to taxation; while Company B with a Gross Income of $2,810,000 (and no tax-free income) has *exactly the same amount* of income subject to taxation. And yet A pays *twelve times* as much tax as B, solely because it has $1,000,000 tax-free income from U. S. bonds. Is not that a tax on U. S. bonds?

(3) The foregoing examples show that of two companies, identic in size of assets, income and business, A, with *a million dollars* tax-exempt in-

come, pays exactly the *same tax* as B, with *no* tax-exempt income; and so the practical effect of the Act is to tax A's tax-exempt income.

While, with the same income subject to taxation, A pays vastly more than B solely because A has invested in U. S. bonds.

Or, stated from a slightly different angle, while B, having *no* tax-exempt securities, is allowed to deduct 4% of its Reserve, A, *solely because it owns tax-exempt securities*, is allowed a *lesser* deduction, in the precise amount of its tax-exempt income; so that A, *solely because it owns tax-exempt securities*, is taxed upon its *other taxable income* a *greater tax* than B, who does *not* own any tax-free bonds. The sole *basis of classification* between A and B, is A's *ownership of tax-exempt* securities; and that differentiation is made the basis of giving B a correspondingly *greater* deduction.

If that is not the precise equivalent of taxing tax-exempt securities, the English language has lost its meaning.

4. *Explanation of the special treatment in income taxation of life insurance companies.* From 1909 to 1920, the various income tax laws taxed life insurance companies (just as other corporations) upon their net income [*i. e.* Gross income *minus* specified deductions], and of course the companies received (as did every individual and corporation) a deduction for all tax-exempt income. All the premiums paid in by policyhold-

ers were included as "gross income" (*Maryland Casualty Co.* v. *U. S.*, 251 U. S. 342, 346-8); but, on account of the peculiar nature of the life insurance business, Congress allowed certain large special deductions summarized in the margin.*

The Revenue Acts of 1909, 1913, 1916, 1917 and 1918, thus recognized that as *premiums were included* as income, the deductions noted in the margin must be allowed in order to *exclude* what the companies (1) paid out to policyholders, or (2) were compelled to retain as legal "Reserve" to meet future death losses as they should occur. This was so, on exactly the same theory that if a State (or Congress) includes in a bank's income or taxable assets *all the money deposited in the bank by its depositors during the year*, it must either (*a*) make the tax infinitesimally small or (*b*) allow as a deduction all the checks drawn by depositors during the year, plus the amount owing to depositors at the end of the year (Cf. *Deposit Bank of Owensboro* v. *Daviess County*, 102 Ky. 174 at 214; *Com.* v. *Bank of Commerce*,

*The special deductions so allowed (1913-1920) were (1) the net addition required by law to be made within the taxable year to Reserve funds; (2) sums other than dividends paid within the taxable year on policy and annuity contracts; and (3) in the 1918 Revenue Act, such portion of any actual premium received from any individual policyholder as is paid back or credited to, or treated as, an abatement of premium of such policyholder within the taxable year (Act August 5, 1909, §38, 36 Stat. 113; Act Oct. 3, 1913, Section II G (b), 38 Stat. 172-3; Revenue Act of 1916, §12 (a), 39 Stat. 767-8; Revenue Act of 1917, 40 Stat. 302-305; Revenue Act of 1918, §§233 (a) (1), 234 (a) 10, 40 Stat. 1077, 1079).

118 Ky. 547, 551-556; *Com.* v. *Wathen*, 126 Ky. 573, 574; *Branch* v. *Town of Marengo*, 43 Ia. 600; *People* v. *Peck*, 157 N. Y. 51; *In re Haight*, 32 App. Div. 496; *State* v. *Carson Savings Bank*, 17 Nev. 146; *State* v. *American*, 37 N. J. Law, 408; *Petition of Savings Bank*, 68 N. H. 384; *Berry* v. *Windham*, 59 N. H. 288. See also *Clement Nat. Bank* v. *Vermont*, 231 U. S. 120) for otherwise the business would be taxed out of existence.

The language used in the earlier Acts to accomplish these essential deductions had been productive of administrative difficulties and much litigation (*McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585; *Maryland Cas. Co.* v. *U. S.* 251 U. S. 342; *U. S.* v. *Boston Ins. Co.*, 269 U. S. 197; *New York Life Ins. Co.* v. *Edwards*, 271 U. S. 109; *Duffy* v. *Mutual Benefit Co.*, 272 U. S. 613).

The Revenue Act of 1921 contained a provision (first suggested for the 1918 Revenue Act but which had failed of adoption*) designed to simplify the taxation of life companies and also to deprive them of the benefit of holding large amounts of tax-exempt bonds.

The new method, in the first place, entirely *eliminated premiums* from "gross income," which it defined to include only "Interest, dividends and rents." On the other hand, it also

*Cf. §§246 (a) (1) (2), 247 of Senate Amendment 186 to Revenue Act of 1918 (Senate Report No. 617, 65th Cong. 3d Sess. H. R. 12863); §§244 (a), 245 (a) (1) (2) Revenue Act of 1921, 42 Stat. 261.

eliminated from the allowable deductions many items that other corporations were permitted to deduct (Cf. §§234(a), 245). Instead of the former deductions noted in the margin (p. 13, *supra*), it only allowed as deductions, (1) tax-exempt income; (2) the excess, if any, of 4% of Reserve over (1); and (3) certain miscellaneous deductions not in controversy.

The reason for allowing a deduction of 4% of Reserve, was that most, if not all, of the "Interest, dividends and rents" received, had to be used each year in maintaining the Reserve, *i. e.*, adding to it on the basis of a certain interest rate, varying from 3% to 4% according to the requirement of the particular State Statute. The moment the Reserve (though it be *hundreds of millions* of dollars) is impaired a dollar, the Company is insolvent. The Reserve is maintained from the current premiums and the interest earnings on the Reserve. The Reserve is not income in any sense.

Consequently, when Congress allowed a deduction of 4% on the Reserve, it was not an arbitrary *favor*, as the Government assumes, but it was an economic *necessity*, so long as there was any pretense of "income" taxation; though, constitutionally, of course, Congress might have *refused any deduction*, and taxed the business into insolvency.*

*Some courts hold that the Reserve belongs to the company and may be taxed (*In re Oklahoma*, 173 Pac. 376, 13 A. L. R. 174; *Com. Life v. Kentucky*, 145 Ky. 284, 36 L. R. A. (N. S.) 226), while other courts hold that the Reserve is a *debt* (*Alabama Gold Life Ins. Co. v. Lott*, 54 Ala. 499; *Insurance Co. v. Board of Equalization*, 74 Iowa 178; *Insurance Co. v. Detroit*, 133 Mich. 408.

(5) *The opinion of the Court of Claims.* The Court of Claims held:

> First: That as §245 (a) (1) authorized a *deduction* of tax-exempt income, such income was *not taxed* (R. 19, 20); and that the National Life's constitutional exemption was thus, once and for all, allowed.
>
> Second: That insurance companies had no constitutional right to the further deduction of 4% of their Reserves (R. 20, 23); that Congress could authorize such further deductions as it chose to define (R. 22); *that it could use the amount of tax-exempt income as an element in measuring the additional deduction to be allowed* (R. 23); and the fact that some companies had tax free income, while others had a lesser amount or none at all [and thus secured a larger deduction and consequently paid a smaller tax], was a mere difference in circumstance that did not affect the validity of the Act nor render it arbitrary or discriminatory (R. 22, 23).

The error in the Court of Claims' reasoning is involved in the italicized words *supra*. It wholly failed to realize that Congress' undoubted right to grant or refuse additional statutory deductions, was not absolute, but was *impliedly limited* by the fact that it could not annex thereto any *unconstitutional conditions* (p. 57, *et seq.*).

It could not lawfully make the amount of deduction to vary inversely with the amount of tax-exempt income; for that would be the equivalent of saying that *to the extent* that a company availed itself of a constitutional right it should

be denied some privilege, which otherwise it could, in common with all others of the same class, enjoy. That would be to penalize the enjoyment of a constitutional right. Congress cannot do so.

The Court of Claims erred in dismissing the National Life's petition (R. 25); and in refusing to hold that Congress exceeded its power when it made the denial or allowance of a Congressional benefit depend upon the respective exercise or renunciation of a constitutional right.

SUMMARY OF POINTS DISCUSSED.

I. §245(a)(2) is unconstitutional in so far as it *reduces* the 4% of Reserves exemption, by the *exact amount* of the National Life's tax-*exempt* income; and this is so because its purpose and effect are to tax the income from tax-exempt bonds (pp. 19-49, infra).

1. Congress cannot tax (1) instrumentalities of the States nor (2) the income from U. S. bonds which it has expressly exempted from taxation (p. 19, *infra*).
2. The effect of §245(a)(2) is to tax the income from tax-free securities (p. 20, *infra*).
3. Chronological review of authorities condemning the plan embraced in §245(a)(2) (p. 26, *infra*).

I.

U. S. v. *Ritchie*, Fed. Cas. 16168.
People v. *Commissioners*, 41 How. Pr. 459.
People v. *Weaver*, 100 U. S. 539.
Farmers' Bank v. *Minnesota*, 232 U. S. 516.
Evans v. *Gore*, 253 U. S. 245.
Miles v. *Graham*, 268 U. S. 501.

II.

THREE CASES DIRECTLY IN POINT (p. 35, *infra*).

City of Waco v. *Amicable Life Ins. Co.*, 230 S. W. 698, 248 S. W. 332.
Motor Car Co. v. *City of Detroit*, 232 Mich. 245.
Miller v. *Milwaukee*, 272 U. S. 713.

II. If the device of §245(a)(2) is sustained in the case at bar, then the States and Congress can easily nullify many of this Court's important decisions exempting property from taxation, and thereby tax United States bonds and other tax-exempt property (pp. 49-57, infra).

1. Illustrations of how simple Amendments to the Statutes held void in the following cases, can tax the property held exempt (p. 49, *infra*).

Evans v. *Gore*, 253 U. S. 245.
People v. *Weaver*, 100 U. S. 539.
Lou. & Jeff. Ferry Co. v. *Kentucky*, 188 U. S. 385.
Bank of California v. *Richardson*, 248 U. S. 476.
Frick v. *Pennsylvania*, 268 U. S. 473.
Miller v. *Milwaukee*, 272 U. S. 713.
Northwestern Ins. Co. v. *Wisconsin*, 275 U. S. 136.

III. Response to the arguments made by the Government and Mr. Hughes in the Court of Claims (pp. 57-65, infra).

1. Congress' power to grant or refuse deductions does not authorize "*unconstitutional conditions*" of deduction. The *ownership* of tax-exempt securities cannot be made the *basis of a classification*, whose sole purpose is to more heavily tax those who hold tax-exempt securities than those who do not hold them (pp. 57-62, *infra*).

Federal Land Bank v. *Crosland*, 261 U. S. 374, 378.
Miller v. ***Milwaukee***, 272 U. S. 713, 715.
Nichols v. ***Coolidge***, 274 U. S. 531, 541-2.

2. The tax cannot be sustained on the ground that it may be measured by income regardless of the tax-free character of such income (p. 62, *infra*).

Frick v. *Pennsylvania*, 268 U. S. 473, 494.
Evans v. *Gore*, 253 U. S. 245, 263.
Gillespie v. *Oklahoma*, 257 U. S. 501, 505.
Miller v. *Milwaukee*, 272 U. S. 713, 715.
Nichols v. *Coolidge*, 274 U. S. 531, 541.
Northwestern Ins. Co. v. *Wisconsin*, 275 U. S. 136, 141.

3. The tax is an *income* tax and it is not an *excise* tax (p. 64, *infra*).

Revenue Acts of 1913, 1916, 1917, 1918, 1921.

FIRST POINT.

§245(a)(2) is unconstitutional in so far as it reduces the 4% Reserve exemption, by the *exact amount* of the National Life's tax-*exempt* income; and this is so because its purpose and effect are to tax the income from tax exempt bonds.

1. Congress cannot tax the means and instrumentalities of the States, nor the income from State or municipal bonds;* and we shall likewise assume, without argument, that Congress cannot tax the income on Liberty bonds, which it has expressly exempted from the normal tax—for to do so would be to violate the due process clause of the Fifth Amendment (*Choate* v. *Trapp*, 224 U. S. 665, 673, 674; *Union Pacific R. R. Co.* v. *U. S.*, 99 U. S. 700, 718, 719; *Nichols* v. *Coolidge*, 274 U. S. 501, 542, 543, McREYNOLDS, J., *in Blodgett* v. *Holden*, 275 U. S. 142, 147; *Farmers Bank* v. *Min-*

*See authorities cited at p. 9, note, *supra*; *Freedman* v. *Sigel*, 10 Blatchf. 327.

nesota, 232 U. S. 516, 528; *Home of Friendless* v. *Rouse*, 8 Wall. 430; *Wilmington & Raleigh R. Co.* v. *Reid*, 13 Wall. 264; *Frick* v. *Pennsylvania*, 268 U. S. 473, 489.

The sole question then is this: Does §245(a)(2), in fact, tax the income from tax-exempt bonds? If so, the provision is void. No one will dispute that.

It was openly avowed that §245(a)(2) was "devised in order *not* to give them [life companies holding tax free bonds] exemption from tax-exempt bonds," because "the theory of the [income] tax *does not justify* any real exemption from tax-exempt income" (pp. 8, 9, *supra*). That should be given great weight in view of the increasing liberality in looking to Committee Reports, etc., to ascertain the *object* of statutes.*

2. As shown above (pp. 7, 10, 11, *supra*), the actual *effect* of the Act was to carry out the avowed object and to tax the income from tax-exempt securities; and its effect may be clearly seen as follows (pp. 7, 8, *supra*):

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*Dunlap v. U. S., 173 U. S. 65, 75; Binns v. U. S., 194 U. S. 486, 495; Johnson v. Southern Pacific Co., 196 U. S. 1, 20; Pennsylvania R. R. Co. v. International Coal Co., 230 U. S. 184, 198-199; U. S. v. Coca Cola Co., 241 U. S. 265, 281, 283; U. S. v. St. Paul M. & M. Ry., 247 U. S. 310, 318; Evans v. Gore, 253 U. S. 245, 248; Duplex Printing Co. v. Deering, 254 U. S. 443, 475.

Net Income = Gross Income — Exempt-Income — [4% Reserve — Exempt-Income].

Clearing bracket:

Net Income = Gross Income — Exempt-Income — 4% Reserve + Exempt-Income.

Cancelling + and — items against each other:

Net Income = Gross Income** — 4% Reserve.

The taxable net income thus includes all income derived from United States bonds or from State bonds.

The Government must admit that Congress cannot require interest from tax-exempt bonds to be *included* in "gross income," without providing for an equally effective *deduction;* and it must also admit that Congress could not first include tax-exempt income, allow a deduction therefor, and then provide that the deduction should be cancelled.

Is the result varied, if, instead of cancelling the deduction of tax-exempt income, Congress in granting a subsequent statutory deduction or exemption, provides that in all cases of holders of tax-exempt securities, the Statutory deduction (otherwise allowable) shall be cut down by just the amount of their constitutionally exempt income? Obviously not, because that course would cancel the original deduction just as effectively as if that original deduction were cancelled in express terms.

What Congress did in the Revenue Act of 1921 was to authorize life companies to subtract

** "Gross Income" is expressly *defined* to include "Interest" (§244 (a)); and the Collector of Internal Revenue compelled the National Life to file an amended return including its tax-*exempt* interest income from both State and Federal securities in its "Gross Income."

4% of their Reserves from their taxable income, and to levy a 10% tax on the remainder. But, in case any company had non-taxable bonds, Congress *reduced* the deduction by the *exact amount* of the non-taxable income. Consequently, life companies having no tax free bonds or only small amounts thereof, deducted from their taxable income all, or almost all, of the full 4% Reserve statutory deduction; *whereas*, all companies like the National Life, having a very large proportion of their assets invested in State and Government bonds, were not given the full 4% deduction, but were taxed upon a greater amount of income—the *excess* so taxed being the *precise amount of their tax free income*. Can anything be clearer than that a burden was directly imposed upon the ownership of tax free securities?

3. We lay aside as inapplicable (for the reasons given in *Northwestern Mutual Life Ins. Co. v. Wisconsin*, 275 U. S. 136 (November 21, 1927)) all those cases (1) involving State taxation affecting interstate commerce, but without unreasonably burdening it, whether depending upon gross earnings (*U. S. Express Co. v. Minnesota*, 220 U. S. 335; *Cudahy Packing Co. v. Minnesota*, 246 U. S. 450), or upon net income (*U. S. Glue Co. v. Town of Oak Creek*, 247 U. S. 321, 328), and (2) involving taxes on privileges or franchises, whether measured by dividends (*Home Ins. Co. v. New York*, 134 U. S. 594), or by net income (*Flint v. Stone-Tracy Co.*, 220 U. S.

107); because, as aptly said in *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*,

> "Certainly since *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505, it has been the settled doctrine here that where the principal is absolutely immune, no valid tax can be laid upon income arising therefrom.* To tax this would amount practically to laying a burden on the exempted principal. Accordingly, if the challenged Act, *whatever called*, really imposes a direct charge upon interest derived from United States bonds, it is *pro tanto* void."

In that case, a 3% Wisconsin Income Tax upon an insurance company's gross income (excepting income from rents and premiums) was held *pro tanto* void, in so far as the tax was calculated upon the interest received by the company from United States bonds.

This Court said (275 U. S. 141):

> "Here the statute undertook to impose a charge of 3 per cent. upon every dollar of interest received by the Company from United States bonds. So much, in any event, the State took from these very receipts. This amounts, we think, to an imposition upon the bonds themselves and goes beyond the power of the State."

Congress takes 10% out of every dollar of interest received by the National Life from its State and United States bonds. This amounts to an imposition upon the bonds themselves, and is beyond the power of Congress.

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*How far, if at all, that "settled doctrine" modifies the reasoning in *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, and *Plummer* v. *Coler*, 178 U. S. 115, is interesting but irrelevant here.

Does §245 a (2) really impose a direct charge upon interest derived from State and Federal bonds?

While the distinction between an imposition, the amount of which depends upon *net* receipts, and one which is measured by *gross* income, is clear, and is often the determining factor in a field where the taxing authority has some freedom of action, as in incidentally affecting interstate commerce or taxing privileges or franchises, nevertheless that *distinction* (between basing the tax upon *net* income rather than *gross* income) *disappears* in the field where the subject-matter is *wholly beyond* the power of the taxing authority, as is the case of States taxing bonds or instrumentalities of the United States, or of the United States taxing bonds or instrumentalities of the States, or of the States taxing property beyond its limits. (*Evans* v. *Gore*, 253 U. S. 245, 263; *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*, 275 U. S. 136; *Farmers Bank* v. *Minnesota*, 232 U. S. 516, 528.)

In *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505, it was held that an Oklahoma tax upon net income could not lawfully reach net income derived by the tax-payer as lessee of leases of certain Indian lands; that the leases and the lessee were instrumentalities of the United States in carrying out its duties to the Indians; and that the interstate commerce tax cases were not applicable, because if property was exempt its *income* was also exempt. Referring to those cases which

had sustained taxation, which to some extent affected interstate commerce, the Court said:

> "The rule as to instrumentalities of the United States on the other hand is *absolute in form* and at least stricter in substance. *Williams* v. *Talladega*, 226 U. S. 404, 416, 417, 419. *Johnson* v. *Maryland*, 254 U. S. 51, 55. 'A tax upon the leases is a tax upon the power to make them, and could be used to destroy the power to make them.' 240 U. S. 530. The step from this to the invalidity of the tax upon income from the leases is not long.
>
> "In cases where the principal is absolutely immune from interference an inquiry is allowed into the *sources* from which *net* income is derived and if a part of it comes from such a source the tax is *pro tanto* void; *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429; 158 U. S. 601; a rule lately illustrated by *Evans* v. *Gore*, 253 U. S. 245; and applied in a case somewhat like the present by the Supreme Court of Hawaii. *Oahu Ry. & Land Co.* v. *Pratt*, 14 Hawaii, 126. Whether this property could be taxed in any other form or not, it cannot be reached as profits or income from leases such as those before us. The same considerations that invalidate a tax upon the leases invalidate a tax upon the profits of the leases, and, stopping short of theoretical possibilities, a tax upon such profits is a direct hamper upon the effort of the United States to make the best terms that it can for its wards. *Weston* v. *Charleston*, 2 Pet. 449, 468."

The most pertinent authority is *Miller* v. *Milwaukee*, 272 U. S. 713 (p. 46, *infra*), but a chronological review of the cases will be instruc-

tive as showing the consistent judicial condemnation of the plan of §245(a)(2).

CHRONOLOGICAL REVIEW OF AUTHORITIES CONDEMNING THE PLAN EMBRACED IN §245 (a) (2).

In *U. S.* v. *Ritchie*, Fed. Cas. 16168 (1872), the Federal income tax law then in force allowed a $1,000 statutory exemption (14 Stat. 478); and the Government insisted that even if a State official's salary were exempt from Federal taxation (*Collector* v. *Day*, 11 Wall. 113), yet $1,000 of the salary should be applied to the exemption.

The respective contentions may be thus formulated:

Ritchie's Contention:

Net Income = [Gross Income — Salary] — $1,000
= Gross Income — Salary — $1,000

United States' Contention:

Net Income = Gross Income — [Salary — $1,000]
= Gross Income — Salary + $1,000

The difference between the parties was thus the tax on $2,000 of income. The Court held that the Government's method was wrong, and that Ritchie's was correct, holding:

> "that the United States could not apply the compensation of a state officer to the satisfaction of the exemption alone, because that would, indirectly, make his income from such source liable to the taxation from which it is exempt; that to exhaust the exemption clause by taking the amount out of his official income, would be to make it, in effect, subject to the revenue law, and to deny to a state's

officer the advantage of the state's exemption, and that therefore the official income of defendant was not to be taken into consideration in the assessment of the tax."

The United States need not have given to the taxpayer the $1,000 exemption. That was a deduction which Congress could give or not, as it saw fit. But having once given that exemption, it could not exhaust it by applying it against the already constitutionally tax-exempt state salary. Why not? Because, as the Constitution impliedly prohibits Federal taxation of State salaries, Congress cannot evade that prohibition by saying that an exemption, otherwise allowable, shall be *pro tanto* consumed by the constitutional exemption. The point of the case is that whatever income is constitutionally exempt from Federal taxation, must be treated as *non-existent*, in determining the Federal tax due. Any item that is constitutionally exempt from Federal taxation must either be entirely excluded from the calculation of gross income, or if it is first included in gross income, it must be *unqualifiedly* deducted therefrom; and it cannot be taken into consideration in determining the amount of some *other* deduction or in applying such other deduction. If, in the *Ritchie* case it had happened that the state salary had been the amount of the exemption, to wit: $1,000, or less, then, according to the Government's contention at that time, if the salary had been just $1,000, Ritchie would have had to pay an income tax upon his full income, *including the State salary*, without any deduction whatever. Or, if the salary

had been less than the $1,000 exemption, he would have had to pay a Federal Income Tax upon his full income, including a State salary, less only the *difference* between the salary and the $1,000 exemption.

The Revenue Act of 1921 presents a sort of converse to the Government's contention in the *Ritchie* case. Instead of providing, as the Government urged in the *Ritchie* case, for a subtraction of the statutory deduction from the exempt salary, it provides that the exempt income shall be subtracted from the $1,000 statutory deduction. But the same vice exists in both, namely: the statutory deduction is not conceded absolutely and independently of the non-taxable income, but, in each instance, the statutory deduction is sought to be reduced by the amount of the constitutionally exempt income. The Government's contention in the *Ritchie* case was judicially disapproved; and the same contention, now crystallized in the 1921 Revenue Act, should likewise be disapproved.

In *People* v. *Commissioners*, 41 How. Pr. 459, a New York statute allowed the deduction of a man's debts in determining the assessed value of his property. One Babbitt's financial condition was as follows:

Taxable assets	$345,000
United States Bonds	250,000
Total assets	$595,000
Debts	356,000
Net worth	$239,000

The taxing authorities contended that they were entitled either (1) to deduct his debts (as above) from his total assets; or, what was the same thing, (2) deduct his United States Bonds from his debts (so as to find out what his net debts were), and then to deduct such net debts from his taxable assets, expressed algebraically as follows:

(1) Assessed Value = Taxable Assets + United States Bonds — Debts.
Or what is the same thing:
(2) Assessed Value = Taxable Assets — [Debts — United States Bonds].
Taxable Assets = Debts + United States Bonds.

In either event assessing his U. S. bonds for taxation.

On the other hand, Babbitt contended that his United States bonds, being exempt from taxation, could not be taken into consideration in any way in determining the value of his property subject to taxation; and especially that their ownership could not be made an excuse for *reducing* the deduction for indebtedness to which he was entitled, by the precise amount of such U. S. bonds.

It was held, without opinion, that no tax was due.

The state did not have to give to a taxpayer any deduction at all on account of debts. It could give a deduction or not, exactly as it pleased. It might grant the deduction on any terms it chose, *except that it could not make the possession of United States bonds an element in determining what deduction it would allow*, as

such a course would be the equivalent of taxing United States bonds and imposing a burden upon a tax-payer, *because of his ownership of United States bonds*—which is the same thing as imposing a burden or taxing the bonds themselves.*

In *People* v. *Weaver*, 100 U. S. 539, a New York statute taxed personalty as follows:

> Taxable Value = Personal Estate — [Debts + stock in *taxed* corporations]

Stock in National Banks was included in "Personal estate"; but as national banks are *non*-taxed on their stock, such stock was not included in the deduction. This Court held that the statute was void *because it did not allow the same deduction for debts* for a holder of national bank stock that it allowed to a holder of other moneyed capital. The Court said:

> "Nor • • • can it be denied that the owner of such shares who owes debts is subjected to a heavier tax on account of those shares than the owner of moneyed capital otherwise invested, who is also in debt, because the latter can diminish the amount of his tax by the amount of his indebtedness, while the former cannot. • • •
>
> "We are, therefore, of opinion that the statute of New York, as construed by the Court of Appeals, in refusing to plaintiff the same deduction for debts due by him, from the valuation of his shares of National Bank

*Although the report does not so indicate, it is of course possible that the decision might be explained on the theory that a proper interpretation of the state statute required a deduction of debts from his *taxable* property only; and, hence, it might be contended that this case did not even touch the question whether the State could have lawfully provided for a deduction of only *net indebtedness*, after first deducting the value of exempt securities.

> stock, that it allows to those who have moneyed capital otherwise invested, is in conflict with the act of Congress."

As there, so here; an insurance company is subjected to a heavier tax on account of tax-free bonds than is the owner of railroad bonds, because the latter can diminish the amount of his taxable income by the amount of 4% Reserve, while the former cannot. §245 (a) (2) *refuses* to the National Life the same deduction for Reserve from its income, that it *allows* to those who do not own Government bonds. If that is not discrimination against U. S. bonds, what is?

In *Farmers Bank* v. *Minnesota*, 232 U. S. 516, 528, a Minnesota statute taxed the *net* surplus of savings banks, which was to be determined by deducting from its total assets, the amount of its deposits, accounts payable and real estate. The bank's total assets were about $12,000,000; and when its deposits, other debts and real estate were deducted therefrom it left a net surplus of about $285,000, which the state taxed; while if the bank's $700,000 tax-exempt securities had been treated as non-existent and left out of all consideration, there would have been no net surplus whatever, but an actual deficit, and consequently no tax due.

Although this was a tax upon *net* surplus, ascertained after including and deducting many items of large amount, and thus only apparently indirectly affecting the tax-exempt securities, this Court held that the $700,000 of tax-exempt bonds

must be treated as non-existent, could not be deemed to have been included in the deductions made for deposits and other debts, but must be wholly excluded from any consideration whatever in the ascertainment of the net surplus subject to taxation. The Court said:

> "It is, however, further suggested that the judgment under review does not sustain a tax upon the bonds as property, but only a tax upon the surplus of the Savings Bank, computed by taking into the account all of its assets, amounting to about $12,000,000, of which the bonds were only about $700,000, and deducting therefrom its liabilities. But as the surplus is treated as property and taxed as such, it is obvious that some portion of the burden of the tax is attributable to the ownership of the municipal bonds. In *Bank of Commerce* v. *New York City*, 2 Black, 620, it was held that the State of New York in taxing the capital of banks according to its valuation must leave out of the calculation that portion of the capital invested in the stocks, bonds, or other securities of the United States not liable to taxation by the State. And see *Bank Tax Case*, 2 Wall. 200; *Home Savings Bank* v. *Des Moines*, 205 U. S. 503, 509.
>
> "It results that the inclusion of the bonds now in question in the list of the assets of plaintiff in error, in ascertaining its surplus for the purpose of imposing a state property tax thereon, was repugnant to the Constitution of the United States."

In *Evans* v. *Gore*, 253 U. S. 245, and *Miles* v. *Graham*, 268 U. S. 501, the Revenue Act of 1918, levying an income tax upon *net* incomes, provided for including the salaries of Federal

Judges in "gross income" (from which by various deductions the "*net* income" was determined). The Constitution provides that the compensation of Federal Judges "shall not be diminished during their continuance in office." Although each judge in question received from the Government the full compensation fixed by law, it was held that even a tax upon *net* income was void in so far as "his judicial salary was treated as part of his 'gross income'," because it was the equivalent of diminishing the compensation.

The Court said, in *Evans* v. *Gore* (p. 254):

> "Obviously diminution may be effected in more ways than one. Some may be direct and others indirect, or even evasive, as Mr. Hamilton suggested. But all which by their necessary operation and effect withhold or take from the judge a part of that which has been promised by law for his services must be regarded as within the prohibition. Nothing short of this will give full effect to its spirit and principle. Here the plaintiff was paid the full compensation, but was subjected to an involuntary obligation, to pay back a part, an obligation which was promptly enforced. Of what avail to him was the part which was paid to him with one hand and then taken up with the other? Was he not placed in practically the same situation as if it had been withheld in the first instance? Only by subordinating substance to mere form could it be held that his compensation was not diminished. Of course, the conclusion that it was diminished is the natural one. * * * The taxing Act directs that the com-

pensation—the full sum with no deduction for expenses—be included in computing the net income on which the tax is laid. If the compensation be the only income the tax falls on it alone; and if there be other income the inclusion of the compensation augments the tax accordingly. In either event the compensation suffers a diminution to the extent that it is taxed."

Although the 1918 Revenue Act only taxed *net* income the *Evans* and *Graham* cases both held expressly that the inclusion in "gross" income of the judicial salary, rendered *pro tanto* void even the tax upon *net* income. The importance of that holding is emphasized by the fact that this Court deliberately considered and rejected the contrary argument advanced by the dissenting Justices (HOLMES and BRANDEIS, J. J.) that *Peck & Co.* v. *Lowe*, 247 U. S. 165, and *U. S. Glue Co.* v. *Oak Creek*, *Ibid*, 321, held that if the tax were laid only on *net* income rather than gross receipts it would be good. Although Mr. Justice HOLMES, in dissenting (253 U. S. at 265), urged that in a tax upon *net* income there should not be an inquiry into the sources from which the final item was derived, this Court rejected that argument and held that it would look back to see if the sum, upon which the income tax was levied, was in fact composed in part of income that was constitutionally exempt from taxation. (HOLMES, J., recognizes that such is now the settled rule, *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505):

Although *Evans* v. *Gore* and *Miles* v. *Graham* are not as directly in point as either the cases

heretofore reviewed or those now about to be reviewed, still they are important as establishing the doctrine that *if income* (whether judicial salary or interest from tax free bonds) *is exempt* from diminution or seizure by governmental authority, **it cannot be diminished or taken by the device of compelling its inclusion in "gross" income as the basis from which "net" income is ascertained. The exempted income must be, for purposes of taxation, treated as non-existent.**

In the case at bar, the National Life insists that its interest from State and Federal bonds should be treated, for tax purposes, as being as completely *non-existent*, as *Evans* v. *Gore* and *Miles* v. *Graham* held that a judicial salary should be treated as non-existent when it came to tax purposes.

THREE CASES DIRECTLY IN POINT.

(1) In *City of Waco* v. *Amicable Life Ins. Co.*, 230 S. W. 698 (1921), the company's financial condition, on January 1, 1919, was as follows:

Real Estate	$ 926,652.97	[Assessed Value $589,650]
U. S. Bonds	906,050.00	
Other Assets	1,381,730.26	
Total Assets . . .	$3,214,433.23	[Including $1,631,754.06 Reserve]

The Texas statute required that the company's assets be assessed as follows:

[Total Assets — Reserve] — Assessed Value of Real Estate.

The Insurance Company contended that its U. S. bonds must be treated as *non-existent* and should not be included in the total valuation of

its assets; or, if so included, then deducted after the remainder prescribed by the statute had been ascertained, to wit:

[Total Assets — U. S. bonds — Reserve] — Assessed Value of Real Estate

Or, what is the same thing:

[Total Assets — Reserve] — Assessed Value of Real Estate — [U. S. Bonds]

The City contended, as does the Government here, that as the State need not have allowed any deduction whatever for Reserve or anything else, the State had the absolute right to prescribe just what such gratuitous deduction should be and how it should be ascertained; and that if, from the Total Assets, there was in fact deducted (whether in the shape of Reserve or otherwise) an amount equal to the U. S. bonds, the result was to secure to the company the exemption of its U. S. bonds; or, in other words, if in deducting the amount of the Reserve, there was a deduction equal to the amount of the exempt bonds (by reason of the fact that the Reserve was invested in such bonds), then taxing the remainder was not a tax on the bonds.

The City's formula was this:

[Total Assets — Reserve (including therein the value of all U. S. bonds)] — Assessed Value of Real Estate.

The Court sustained the Insurance Company's position; and held that the Act authorized the deduction of the Reserve without condition, regardless of whether it was invested in exempt securities or not, "upon the theory that its amount is not an asset but is a liability" and "the Legis-

lature intended this deduction as an allowance for the debts of the corporation," and that U. S. bonds being *tax-exempt*, must be treated as *non-existent*, saying:

> "In the present case, if we eliminate the exempt bonds, in the first instance, and then the legal reserve and the value of the real estate are deducted from the remainder of the property, there would be nothing left, for these three items exceed the total assets of the company. If we should include the exempt bonds in the total valuation, and deduct the amount of the real estate and the amount of the legal reserve without regard to its investment, the remainder would be only $656,025.30 which would be more than offset by the amount of the bonds, which is $906,050. By either process, if we give full effect to the federal statutes exempting the bonds, there would be nothing left for taxation as personal property; and therefore the entire assessment by the city was illegal and void. * * *
>
> "The effect of this statute, we think, must be that in any scheme of state or municipal taxation *such securities must be eliminated from consideration in any equation to reach the taxable property*, or, at least, when they are included, compels a deduction as such, for the amount of the exempt bonds. * * * if after the deduction of the real estate and of the legal reserve, without regard to its investment or what it represents, there remains a sum which is equaled or exceeded by exempt state or federal securities, there is no remainder subject to taxation."

KEY, C. J., in a concurring opinion (230 S. W. 703) pointed out that the "Reserve" was not a fund at all, but was a mere debt; and, referring to the definition of "Reserve," said:

"Attention is called to the fact that the legislative definition, defining that which should be deducted from the total valuation of assets, does not embrace any fund or property whatever, and includes nothing but debts of a particular kind. A debt is, in no sense whatever, property belonging to the debtor, and therefore it cannot be by him sold or otherwise invested. It may be true that insurance companies and others may designate the liability of such companies to their policyholders as a reserve fund, but as a matter of fact they are mere debts, and constitute no higher claim against the assets of such companies than do the debts of other creditors; therefore, correctly speaking, there is no such thing as a reserve fund of insurance companies upon which policyholders have a superior claim. But be that as it may, in reference to taxation the Legislature has defined what it meant by the use of the term 'reserve.' That definition includes nothing except debts of insurance companies by reason of their outstanding policies, and such being the case, even if they have certain sums of money set aside as a reserve fund for the purpose of paying such debts, it is the amount of the debts and not the amount of such fund which the statute declares shall be deducted from the gross assets; and therefore it seems plain to me that in this case the insurance company was entitled to deduct its entire indebtedness to policyholders, regardless of how any of its funds may have been invested. In this case, when that and the other deductions authorized by the statute are made, the remainder is less than the amount the insurance company had invested in bonds issued by the federal government, and as they are exempt it had no personal property subject to taxation.

"I concur with the trial court and Mr. Justice BRADY that for the purpose of taxation insurance companies have the right to

insist that *all property exempt from taxation shall be excluded in determining upon what property and at what valuation* taxes shall be paid."

On writ of error, the judgment was affirmed (*City of Waco* v. *Amicable Life Ins. Co.*, 248 S. W. 332), where it was pointed out, at some length, that the "Reserve" is merely a debt which the company owes, and that the provision for its deduction from Total Assets (which included the funds in which the Reserve was invested), was merely a deduction of *debts*. The Court said:

> "We have reached the conclusion that the trial court and the Court of Civil Appeals correctly held that *tax-free* government securities *cannot be taken into account in estimating the total value of the company's assets.* • • •
>
> "We have serious doubt whether the Legislature had the power under the method it adopted for assessing the personal property of the company to take into consideration for any purpose the tax-free government securities. The deduction allowed for the reserve, it is true, was a deduction which the Legislature was not required to make; and in making it, the Legislature had, no doubt, the power to reduce the amount of this deduction by offsetting against it the value of any specific property of the company. In other words, the Legislature had the power to limit the deduction to a particular character of the company's assets. For example, we see no reason why the Legislature could not limit the deduction from the total personal assets of the company to the amount by which the reserve might exceed the real estate of the company. But the statute does not provide for the deduction to be made from any particular

character of assets. It is general, and taken from the gross. Under this method the effect of including the tax-free securities in the gross assets necessarily requires the offsetting of those assets against the reserve up to its full amount. It would be impossible, therefore, for the company to obtain the benefit of investing its funds in tax-free securities unless it invested an amount sufficient to cover the reserve and leave a surplus; and in that event it would be benefited by the tax-free character of its securities only to the extent of this surplus. We are strongly inclined to the view that, if the statute be interpreted to require an inclusion of tax-free securities in the gross assets of the company, it would be violative of the United States statutes exempting these securities from taxation. • • • in determining the total assets of the company *no account can be taken of the government tax-free securities.*"

The Court held that the proper formula* was (248 S. W. 336)

Total Assets—U. S. bonds—Reserve—Assessed Value of Real Estate

thereby completely relieving the U. S. bonds from taxation.

(2) In *Motor Car Co. v. City of Detroit*, 232 Mich. 245, a Michigan statute taxed all "credits" (*i. e.*, choses in action), except such as were tax-exempt (*i. e.*, U. S. bonds, etc.). The statute also allowed the following *statutory deduction* or exemption, the italicized proviso of which the Packard Co. insisted was unconstitutional because its effect was to tax U. S. bonds:

*There is a misprint in the opinion: $776,628.27 should be $676,628.27.

"So much of the debts due or to become due as shall equal the amount of *bona fide* and unconditional debts by the person owing: *Provided That if such person shall be the owner of credits that are exempt from taxation, such proportion only of his indebtedness shall be deducted from debts due or to become due as is represented by the ratio between taxable credits and total credits owned, whether taxable or not.*"

The Packard Co.'s financial position for 1923 was as follows:

Tax-*exempt* "credits" (mostly U. S. bonds)	$12,272,474
Taxable "credits"	6,541,620
Total "credits" (whether taxable or not)	$18,814,094
Debts	9,391,045

The Packard Co. insisted that the proviso's italicized words were *pro tanto* void as to its U. S. bonds; that its $12,272,474 tax-exempt "credits" (*i. e.*, U. S. bonds) *could not be considered at all* in the computation of the tax; that in such computation, the U. S. bonds must be treated as *non-existent*; and that it was entitled to the full statutory deduction (or exemption) of its $9,391,045 debts from its $6,541,620 taxable "credits," thus having *no tax* whatever to pay.

Its contention is thus expressed:*

Assessed Value = Taxable credits ($6,541,620) — Debts ($9,391,045).
= —$2,849,425 (a *negative* quantity, on which, of course, no tax could be assessed).

*Taxable "credits"	$6,541,620
Subtract Debts	9,391,045
Deficit	—$2,849,425

The City insisted that according to the italicized proviso, the deduction (instead of being the full $9,391,045 of Debts) should only be such *proportion* thereof as the *Taxable* "credits" ($6,541,620) bore to the *Total* "credits," whether taxable or not ($18,814,094); which is 34.8%, to wit:

$$\frac{6,541,620}{18,814,094} = 34.8\%$$

The City then levied, and the Packard Co. paid under protest, $73,552.80 tax, computed by the proviso as follows:

Assessed Value = [Total credits — Exempt credits] — $\frac{\text{Taxable credits}}{\text{Total credits}}$ [Debts]

which may be tabulated as follows:

Total "credits"	$18,814,094
Exempt credits (U. S. bonds, etc.)	12,272,474
Taxable credits	$ 6,541,620
Deduct	
$\frac{\$6,541,620}{18,814,094}$ (34.8%) of $9,391,045	3,268,083
Credits held subject to taxation	$3,273,537
Tax thereon paid under protest	$73,552.80

The Packard Co. sued to recover the tax.

The effect of the statute on holders and non-holders of tax-free bonds may be thus formulated:

Taxpayer holding tax-exempt "credits"

(1) **Assessment** = Total "credits" — Total debts

Taxpayer holding no tax-exempt "credits"

(2) **Assessment** = Total credits — Tax-exempt "credits" — $\left[\frac{\text{Taxable "credits"}}{\text{Total credits}} \times \text{Total debts}\right]$

Collecting terms and comparing (1) and (2) we have:

$$\text{(1) Total credits} - \text{Total debts}$$

$$\text{(2) Total credits} - \text{Tax exempt credits} - \frac{\text{Taxable credits}}{\text{Total credits}} \times \text{Total debts}$$

That is to say, a taxpayer who owns any U. S. bonds, is compelled to pay, *solely because of such ownership of U. S. bonds*, an additional tax on a valuation represented by the following expression:

$$\left[\text{Total debts} - \frac{\text{Taxable credits}}{\text{Total credits}} \times \text{Total debts}\right]$$

whereas, another taxpayer of exactly the same wealth and indebtedness, but who does not own any U. S. bonds, does not have to pay on that last above item.

Or, stated in another way, a person not holding tax-free bonds, receives a deduction of his *total* debts; whereas a person holding U. S. bonds, only receives a deduction of such proportion of his debts as his taxable credits bore to his total credits.

Michigan was not compelled to allow any deduction for debts; it might have taxed a person's total assets with no deduction whatever for indebtedness; or it could have authorized such total or partial deduction of debts as it saw fit, deter-

mined by any standard, however arbitrary, *except that it could not make the ownership of U. S. bonds a factor in determining that a taxpayer should have a lesser deduction than he would have had if he had not owned Government Bonds.* When the Michigan statute once authorized a deduction of debts from assets, it could not lawfully, by the italicized proviso, *penalize* a taxpayer solely for holding U. S. bonds, by depriving him of just such proportion of his statutory deduction, as his taxable credits bore to his total securities; and that is so because such an action was the equivalent of taking away *pro tanto* the benefit of the constitutional exemption of U. S. bonds from Michigan taxation.

The Supreme Court of Michigan held the proviso void upon that very ground, saying:

> "The provision under which this tax was levied and collected is void. The tax here involved is a property tax. Cases involving franchise, inheritance, and succession tax have no application. Tax exempt credits cannot be taxed, directly or indirectly. In laying a tax on property, *tax exempt credits must be treated as non-existent.* **The Legislature may not make use of, or permit consideration to be taken of tax exempt credits as a factor in determining taxes to be paid by holders thereof. To do so would attach a condition to the enjoyment thereof and impair the underlying contract.** The purpose of this statute is manifest, and the effect thereof touches tax exempt credits not to directly tax them, *but to make the holders pay*

more in taxes by reason of having them. This cannot be done. *Farmers' Bank* v. *Minn.*, 232 U. S. 516. This provision offends against the rule of proportion, intended to insure uniformity of contribution and a just apportionment of the burdens of government, by way of rating the tax upon a consideration of tax exempt credits as well as upon taxable credits and unconditional obligations. *Tax exempt credits may not be considered at all by assessing officers in the matter of determining a property tax*, and they are considered when used as a factor in apportioning the right to set off unconditional obligations against taxable credits. Most of the tax exempt credits held by plaintiff are obligations of the United States government. It was said, in *Home Savings Bank* v. *Des Moines*, 205 U. S. 503, 513:

> " 'The state cannot by any form of taxation, impose any burden upon any part of the national public debt.'

"Confessedly this statute imposes a greater burden of taxation upon a holder of tax exempt credits, along with taxable credits with unconditional obligations, than upon others with taxable credits and unconditional obligations without tax exempt credits.

"Suppose this statute had provided that one holding tax exempt securities should be deprived of right to reduce his taxable credits at all by his unconditional debts. It would indicate no plainer purpose to indirectly place a burden of taxation on tax exempt credits than the provision in question, which, after fixing a right of reduction, based on and governed by a consideration of tax exempt credits, brings the tax exempt credits within the administration of the taxing law. • • •

"The provision of the act, requiring consideration of tax exempt credits in laying the tax, interferes with the power and facility of

the government of the United States to raise money by issuance of tax exempt obligations, impairs the right of freedom from taxation accorded government obligations by the Constitution of the United States, and is void."

(3) In *Miller* v. *Milwaukee*, 272 U. S. 713, Wisconsin corporations owning U. S. bonds collected the interest thereon, credited it to surplus, and later distributed it to their stockholders in dividends of stock or cash. The corporations did not pay any Wisconsin income tax on the interest derived from the U. S. bonds, but paid on all their other income.

The Wisconsin income tax law, as applicable to individuals, provided that their taxable income should include all dividends, both in cash and in stock; but further provided that stockholders should not be taxed on dividends received from corporations whose income was itself taxed; but that if only a part of the income of the corporation was taxed, then only a corresponding part of the dividends received from such corporations should be deducted from the income taxed to the stockholders.

Miller was taxed against his protest that it was an "attempt to make up from him what the State could not take from the corporations [because it] was forbidden by the Constitution and laws of the United States."

This Court assumed, for purposes of argument, that stockholders could be validly taxed by a State income tax on dividends received from corporations whose entire assets were invested in

Government bonds, on the theory that a corporation was a non-conductor between dividends and the funds from which paid (*Des Moines Nat. Bk.* v. *Fairweather*, 263 U. S. 103); but this Court pointed out that it would be a very different matter if the State selected only those companies whose assets were so invested in U. S. bonds, and taxed their stockholders alone. The Court held the Wisconsin tax void, saying:

> "It is a familiar principle that conduct which in usual situations the law protects may become unlawful when part of a scheme to reach a prohibited result. **If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good.** Under the laws of Wisconsin the income from the United States bonds may not be the only item exempted from the income tax on corporations, but it certainly is the most conspicuous instance of exemption at the present time. A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act. On that assumption the immunity of the national bonds is too important to allow any narrowing beyond what the Acts of Congress permit. We think it would be going too far to say that they allow an intentional interference that is only prevented from being direct by the artificial distinction between a corporation and its members. A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it be-

comes a more serious attack upon their immunity when they are its obvious aim. In such a case the Court must consider the public welfare rather than the artifices contrived for private convenience and must look at the facts. See *Home Insurance Co. of New York* v. *New York*, 134 U. S. 594, 598; *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505; *United States Grain Corporation* v. *Phillips*, 261 U. S. 106, 113."

The close analogy of the Wisconsin statute to §245(a)(2) of the Revenue Act of 1921 is manifest when the Wisconsin Act's terms are stated algebraically (see p. 55, *infra*, for full exposition):

Taxable Income = Income — [Dividends received from corporations – Dividends not paid on by corporations because derived from U. S. bonds].

Clearing bracket:

= Income — Dividends received from corporations – Dividends not paid on by corporations because derived from U. S. bonds.

That shows (as in the case at bar) that while Wisconsin was quite willing to give stockholders a deduction of dividends where the corporations paid the Wisconsin income tax, it would not give them such deduction to the extent the corporations held U. S. bonds, and hence paid no Wisconsin income tax thereon.

So, too, the 1921 Revenue Act was quite willing to give life companies a deduction of 4% of Reserve where they had *no* income from State or Federal bonds, but would *not* give such 4% Reserve deduction to the extent the companies had income from State or Federal bonds.

Such an Act certainly is condemned by every reason stated by Mr. Justice HOLMES in the above quotation from *Miller* v. *Milwaukee*.

SECOND POINT.

If the device of §245(a)(2) is sustained, then the States and Congress can easily nullify many of this Court's important decisions exempting property from taxation, and thereby tax United States bonds, and other tax-exempt property.

If this Court shall decide that §245 (a) (2) of the Revenue Act of 1921 is constitutionally permissible, then whenever a taxing authority, State or Federal, is compelled constitutionally to grant a tax-exemption, it may accomplish the prohibited result by *ipso facto* reducing by such exempted amount, deductions otherwise allowable. The door will be wide open for the States, by simple statutory amendments, to nullify many of this Court's most important rulings as to tax-exempt property.

A few illustrations will be illuminating:

In *Evans* v. *Gore*, 253 U. S. 245, the Revenue Act of 1918 provided as follows:

(1) Net Income = Gross Income — Deductions.*

This Court held that §213 was void as applied to Federal Judges' salaries because it required the inclusion of such salaries in the "Gross Income."

The lawful formula then became,

*The deductions allowed were for interest paid on debts, taxes, losses, bad debts, depreciation, and charitable contributions (Revenue Act of 1918, §214; 40 Stat. 1066).

(2) Net Income = Gross Income — Federal Judge's salary — Deductions.

Suppose that, in order to evade *Evans* v. *Gore*, Congress should apply the device of §245(a)(2) to the case of Federal Judges, so that an Amended Act would provide:

(3) Net Income = Gross Income — Federal Judge's salary — [Deductions — Federal Judge's salary].

Clear the bracket:

= Gross Income — Federal Judge's salary — Deductions + Federal Judge's salary.

Cancel identic + and — item of "Federal Judge's salary":

= Gross Income — Deductions.

But that is precisely equation (1) which *Evans* v. *Gore* held to be void. Would this Court approve such a device for evading the constitutional exemption of the Federal Judiciary from a diminution of their compensation during their terms of office?

In *People* v. *Weaver*, 100 U. S. 539, the statute taxed personalty as follows:

(1) Taxable Value = Gross Personal Estate — [Debts + stock in *taxed* corporations]

The Act was held void because it did not allow a deduction for stock in National banks.

Could New York lawfully evade that decision by amending the act (in exact accordance with the device of §245 (a) (2)), so as to read thus:

(2) Taxable Value = Gross Personal Estate — National Bank stocks — [Debts + stock in *taxed* corporations — National Bank stocks]

Clearing bracket:

= Gross Personal estate — National Bank stocks — Debts — Stock in *taxed* corporations + National Bank stocks

Cancelling identic + and — items:

= Gross Personal estate — Debts — stock in *taxed* corporations

= Gross Personal estate — [Debts + stock in *taxed* corporations]

which is the precise result of equation (1) which *People* v. *Weaver* held void.

In *Louisville & Jeffersonville Ferry Co.* v. *Kentucky*, 188 U. S. 385, Kentucky capitalized at 6% the total net earnings of a Ferry Co. plying between Kentucky and Indiana, thereby producing $121,050 as the total value of its entire assets; and then ascertained the value of its franchise or intangible property as follows:

(1) Franchise = Total Value — Assessed Value Ind. & Ky. real and personal property.

This Court held that the Ferry Co.'s Indiana franchise (granted by Indiana to operate a ferry to Kentucky) could not be included in the valuation taxed by Kentucky.

This Court made the taxing statute read thus:

(2) Franchise = Total Value — Indiana franchise — Assessed value of Ind. & Ky. real and personal property.

Could Kentucky evade that decision by amending its act to conform to the decision, and simultaneously nullify it, by the device of §245 (a) (2), so as to make the amended act operate as follows:

(3) Franchise = Total Value — Indiana franchise — [Assessed Value of Ind. & Ky. real and personal property — Indiana franchise]

Clearing bracket:

= Total Value — Indiana franchise — Assessed Value of Ind. & Ky. real and personal property + Indiana franchise

Cancelling identic + and — items of "Indiana franchise":

= Total Value — Assessed Value Ind. & Ky. real and personal property.

But, that is the very valuation in equation (1) which the *Louisville & Jeffersonville Ferry Co.* case said was unconstitutional.

In *Bank of California* v. *Richardson*, 248 U. S. 476, the California [National] Bank had assets and liabilities as follows:

ASSETS:	
2,501 shares in Mills Nat'l Bank	$ 625,546.30
Other assets (about)	$62,374,453.70
Total assets	$63,000,000.00
LIABILITIES:	
Depositors, etc	$47,224,747.33
Capital and surplus	15,775,252.67
Total liabilities	$63,000,000.00

The California statute assessed the stockholders of the California Bank for the value of its assets (after deducting deposits, debts, etc.) at $15,775,252.67, which included $625,546.30 as the value of 2,501 shares of Mills Nat'l Bank stock owned by the California Bank.

This Court held, *inter alia*, that the $625,546.30 value of the California Bank's 2,501 shares of stock in another National bank was exempt from taxation as a part of the assets of the California Bank in taxing the latter's stockholders.

The value of the taxable assets of the California Bank was fixed (1) by the State Court, and (2) by this Court respectively, as follows (omitting cents for typographical brevity):

STATE COURT:

[$15,775,252] [$63,000,000] [$47,224,747]
(1) Taxable Value = Total Assets — Debts to depositors, etc.

THIS COURT:

[$15,149,706] [$63,000,000] [$625,546] [$47,224,747]
(2) Taxable Value = Total Assets — Stock in Mills Bank — Debts to depositors

If now, California, in order to avoid the *Richardson* decision, desired to adopt the device of the Revenue Act of 1921, §245 (a) (2), it could simply amend its act, explicitly provide for the deduction required by that decision, and simultaneously reduce, by an equivalent amount, the other deductions allowed, so that, as amended, the act would provide as follows:

AMENDED ACT:

[$15,775,252] [$63,000,000] [$625,546] [$47,224,747]
(3) Taxable Value = Total Assets — Stock in Mills Bank — [Debts to depositors
[$625,546]
— Stock in Mills Bank]

Clearing bracket:

= Total Assets — Stock in Mills Bank — Debts to depositors
+ Stock in Mills Bank
Cancelling identic + and — items of "Stock in Mills Bank"
[$63,000,000] [$47,224,747]
= Total Assets — Debts to depositors

which is precisely equation (1), *supra*, that this court held was void.

In *Frick* v. *Pennsylvania*, 268 U. S. 473, a State statute, taxing the transfer of property on the death of the domiciled owner, provided that the tax should be laid on the "Clear value" of the estate thus determined:

(1) Clear Value = Gross Value — Debts & Administration Expenses

The Gross value included about $13,000,000 tangible personalty (art treasures, etc.) in New York and Massachusetts; and no deduction was made for the large stock-transfer taxes paid in other States.

This Court held (1) that Pennsylvania could not tax the transfer of the tangible personalty having a situs in other States (p. 494); and (2) that the amount of stock transfer taxes paid in other States must be deducted in determining the taxable value of the estate transferred in Pennsylvania, as all such property was *tax-free* in Pennsylvania, so that the statute should be modified to read as follows:

(2) Clear Value = Gross Value — [Debts & Administration Expenses] — Tangible property in other States — Stock transfer taxes in other States.

Suppose that Pennsylvania, in order to defeat the doctrine of the *Frick* case had granted the deduction required by that case, and simultaneously reduced correspondingly the deduction for "Debts and Administration Expenses," just as §245 (a) (2) of the Revenue Act of 1921 did, so that the "Clear value" would be thus ascertained:

(3) Clear Value = Gross Value — Tangible Property in other States — Stock transfer taxes in other States — [Debts and Administration Expenses — Tangible Property in other States — Stock transfer taxes in other States].

Clearing bracket:

= Gross Value — Tangible Property in other States — Stock transfer taxes in other States — Debts & Administration Expenses + Tangible property in other States + Stock transfer taxes in other States.

Cancelling the identic + and — items:

= Gross Value — Debts & Administration Expenses.

But, that is exactly equation (1) which *Frick* v. *Pennsylvania* said was unconstitutional.

If the Court of Claims is correct that §245 (a) (2) can, by its simple expedient of granting the exemption and then taking it away from the other deductions, thus taxing the National Life's tax-free bonds, then the next Pennsylvania Legislature can similarly nullify *Frick* v. *Pennsylvania*.

In *Miller* v. *Milwaukee*, 272 U. S. 713, this Court held that dividends not paid on by corporations because derived from U. S. bonds, were *exempt* from the Wisconsin individual income tax. Could Wisconsin nullify that decision, through the device of §245 (a) (2), by simply amending the law so as to allow that exemption and simultaneously take it away (Cf., p. 48, *supra*), thus:

Let a = Individual's Gross Income,
b = Dividends received from corporations,
c = Dividends *not* paid on by corporations because derived from U. S. bonds.

The Wisconsin Act provided:

(1) Taxable Income = a — (b — c) = a — b + c.

This Court held the Act void, because it thereby taxed "c."

Suppose in order to circumvent the *Miller* case the Act were amended to read:

(2) Taxable Income = a — c — [(b — c) — c]
= a — c — (b — c) + c
= a — c — b + c + c
= a — b + c

which is precisely the result of equation (1) of the original Act which *Miller* v. *Milwaukee* condemned.

The amended Act would first grant the express deduction of "c" required by the *Miller* case; then it would simultaneously reduce the deduction of (b — c) by the "c"; and when the expression is then algebraically simplified you arrive back at precisely the prohibited result.

Would this Court allow Wisconsin so to defeat the exemption established in the *Miller* case?

In *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*, 275 U. S. 136, a Wisconsin act provided for a 3% gross income tax ascertained as follows:

(1) Taxable Income = Gross Income — Rents — Premiums.

This Court held that the act was *pro tanto* void to the extent that the income taxed included interest on U. S. bonds; and the proper formula then became:

(2) Taxable Income = Gross Income — Interest U. S. bonds — Rents — Premiums.

Can Wisconsin avoid that result by an amended act incorporating the device here involved, so as to make the formula read thus:

(3) Taxable Income = Gross Income — Interest U. S. bonds — [Rents + Premiums — Interest U. S. bonds].
= Gross Income — Interest U. S. bonds — Rents — Premiums + Interest U. S. bonds.
= Gross Income — Rents — Premiums.

But, that is precisely equation (1) which the *Northwestern Mutual* case decided was void.

THIRD POINT.

Response to the arguments made by the Government and Mr. Hughes in the Court of Claims.

1. *Congress' power to grant or refuse deductions does not authorize "unconstitutional conditions" of deduction.* The Government and Hon. CHAS. E. HUGHES, as *amicus curiae*, argued below and also in opposition to the petition for *certiorari*,* that the company had no inherent right to a deduction of any part of its Reserve; that Congress might have refused to give any deduction whatever; that "Deductions are plainly a matter of legislative discretion," and Congress could fix the deduction at 4% of Reserve or at such greater or lesser amount as it chose. We agree to that.

But, such a concession on our part *does not imply* the absolute power to make a *qualified or*

*In Court of Claims, Government's Brief, p. 79, Hughes' Brief, p. 13; Government's Brief opposing *certiorari*, p. 8.

conditional reduction—for then we are faced with the question of "unconstitutional conditions" so earnestly debated in this Court for a half a century, resulting in the settled rule that even the possession of an unqualified power (absolute and unconditional in terms) does not carry with it the uncontrolled right to exercise it in a *conditional* or *qualified* manner; and if exercised in a conditional or qualified manner the condition or qualification must not be repugnant to the Constitution, so as to produce a prohibited result.**

In *Federal Land Bank* v. *Crosland*, 261 U. S. 374, 378, it was held that a State could not exact a tax for recording a Federal Farm Loan mortgage; and in response to the suggestion that recording was not compulsory, and that the Federal Land Bank could refrain from recording it at all, if it chose, this Court said:

> "The State is not bound to furnish a registry, but if it sees fit to do so it cannot use its control as a means to impose a liability that it cannot impose directly, any more than it can escape its constitutional obligations by

**Contrast majority and dissenting views in *Doyle* v. *Continental Ins. Co.*, 94 U. S. 535, 542, 543; *Security Mutual* v. *Prewitt*, 202 U. S. 246, 257, 259, *et seq.*; *Western Union Tel. Co.* v. *Kansas*, 216 U. S. 1, 30-48, 54, 55; *Pullman Co.* v. *Kansas*, 216 U. S. 56, 62, 75; *Ludwig* v. *Western Union Tel. Co.*, 216 U. S. 146, 163; *Southern Ry. Co.* v. *Greene*, 216 U. S. 400, 416; *Herndon* v. *C. R. I. & P. Ry.*, 218 U. S. 135; *Harrison* v. *St. L. & San Francisco R. R.*, 232 U. S. 318, 328, 332, 333; *Phoenix Ins. Co.* v. *McMasters*, 237 U. S. 63, 71. For a full history of the battle over "unconstitutional conditions," see Appellee's Brief (p. 39-76), in *Terral* v. *Burke*, 257 U. S. 529.

denying jurisdiction to its Courts in cases which those Courts are otherwise competent to entertain. *Kenney* v. *Supreme Lodge of the World*, 252 U. S. 411, 415. It is unnecessary to cite cases to show that an act may become unlawful when done to accomplish an unlawful end."

Miller v. *Milwaukee*, 272 U. S. 713, 715, and *Nichols* v. *Coolidge*, 274 U. S. 531, 541-542, illustrate that neither the States nor Congress can exercise a power in such a conditional way as to accomplish a prohibited result.

The application of these principles to the case at bar is plain and simple. Congress had the absolute power to grant, or to refuse to grant, deductions in the shape of a percentage of the Reserves. It could have made such deduction, if allowed at all, 1%, 2%, 3% or any other per cent that, in its discretion, the equitable and economic necessities of the case required. But, it could not lawfully authorize a *conditional* deduction, (1) where the full deduction was allowed, *if* a company held *no* tax-free securities; *whereas*, (2) if a company *held tax-free securities*, the deduction was *made smaller*, in the exact amount of such tax-free securities,—so that the effect was to impose a tax upon tax-free securities, in the precise amount that they would have been taxed, if a tax had been levied upon them *eo nomine*.

The whole point is that the *ownership* of tax-*exempt* securities, can not be made the basis of a classification, whose sole purpose is to tax more

heavily those who hold tax-exempt securities, than those who do not hold them.

The Government can tax anything it pleases, except tax exempts; but it *must deduct tax exempts* from anything on which it imposes taxes. It can give any further deductions that it pleases, and it can ascertain what that deduction shall be in almost any way it pleases.

It can make that deduction equivalent to the man's debts, or to his tangible property, or to his bank stocks, or to his agricultural products, or to any fraction of any of those, but the only qualification is, *that it cannot make the ownership of tax exempts in any way a factor in determining the amount of the deduction.* In other words, it cannot use the ownership of tax exempts in any way, so that such ownership shall work out adversely to any citizen owning such tax-exempt securities.

This is an implied and necessary limitation on the power to give a deduction that would otherwise be wholly within the discretion of the Legislature.

The power of a Legislature to grant, or to withhold, a deduction is not purely a gratuity, which the State can grant or withhold on any terms that it pleases. It cannot make that deduction on such a basis, that the ownership of tax-exempt securities reduces the amount of the benefit that a taxpayer would otherwise have. In other words, the State in making any deduction, or in granting any privilege, cannot make the ownership of tax-exempt securities, result in the taxpayer getting a

less benefit or privilege than he would have had if he had not owned them, because the minute you do that, you are putting a burden on the ownership of the tax-exempt securities.

The reasons why the plan in question is illegal may be reduced to four:

First: Looking at the *ultimate effect* of the Act, the Company is taxed upon its Gross income *minus* 4% on its Reserves, and without any allowance or deduction for its tax-exempt income. Consequently it is taxed on tax-exempt income, which is illegal;

Second: Looking at the Act in its separate parts, it is true that the Act, in the first place, does give an exemption from taxation to tax-exempt income; but it then gives a *qualified* deduction. While Congress can give, or withhold, any deduction it pleases, or can give a partial deduction or deduction as to this, that or the other item, yet it does not follow that, because it can grant a deduction or refuse to give any deduction, it can give any *qualified* deduction that it pleases. The power to give deductions is limited by the fact that it cannot *condition* that deduction with what may be termed an "unconstitutional qualification." It cannot annex to the privilege of a deduction the surrender or subtraction of the constitutional privilege of tax exemption (*Terrall* v. *Burke*, 257 U. S. 529).

Third: Or, looked at from a slightly different angle, the power to grant, or to withhold, *or to qualify*, a deduction is *not* absolute. In granting

a deduction, or in granting a *qualified* deduction, the ownership of tax-exempt securities cannot be made the determining factor as to the amount of the exemption or deduction granted. Stated differently, the ownership of tax-exempt securities cannot be used as a factor adversely to affect the owner thereof, in determining any deduction or privilege that he shall have. A privilege or deduction may be granted or may be withheld; but in granting it, or in withholding it, the ownership of tax-exempt securities can not be made to operate adversely to the owner's interest. In other words, a man cannot be *penalized* (even with respect to something over which the State has apparently complete control) *by the fact that he owns tax-exempt securities.*

Fourth: The Act purports to be something that it is not. While it is true the Government could tax the Gross income, *minus* the tax-exempt income, yet it cannot tax Gross income, *minus* 4% of Reserves, without giving the benefit of tax-exempt income. It is absurd to subtract the tax-exempt income and then add it back on. Regard must be had to the substance of what is done and not merely the form (*Nichols* v. *Coolidge*, 274 U. S. 531, 541; *Child Labor Tax Case*, 259 U. S. 20, 37, 40-43; *Hill* v. *Wallace*, 259 U. S. 44, 67).

2. *The tax can not be sustained upon the theory that it is measured by income regardless of the tax-free character of such income.* In response to the Government's argument that the tax can be sustained as a valid tax merely measured by net

income, even though a part of it is non-taxable, it is sufficient to observe that whatever some of the earlier cases may have said on that subject, the following excerpts from the more modern cases dispose of such a contention.

In *Frick* v. *Pennsylvania*, 268 U. S. 473, 494, the Court said:

> "One ground on which the state court put its decision was that, in taxing the transfer of the property which the decedent owned in Pennsylvania, it was admissible to take as a basis for computing the tax the combined value of that property and the property in New York and Massachusetts. Of course, this was but the equivalent of saying that it was admissible to measure the tax *by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax*, and which necessarily operated to make the amount of the tax *just what it would have been had the State's power included what was excluded by the Constitution*. This ground, in our opinion, is not tenable. It would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail."

Evans v. *Gore*, 253 U. S. 245, 263; *Gillespie* v. *Oklahoma*, 257 U. S. 501, 505; *Miller* v. *Milwaukee*, 272 U. S. 713, 715; *Nichols* v. *Coolidge*, 274 U. S. 531, 541, and *Northwestern Ins. Co.* v. *Wisconsin*, 275 U. S. 136, 141, establish the doctrine that where the principal, as here, is absolutely immune from taxation, even net income partially derived therefrom cannot be taxed; and that inquiry will be permitted into the income taxed, for

the purpose of ascertaining whether it comes from a source which is itself untaxable.

In *Nichols* v. *Coolidge*, 274 U. S. 531, 542, it was pointed out that Congress had no power to levy a tax reckoned upon the value of property it could tax, plus the value of other property it could not tax.

3. *The tax is an income tax and not an excise tax.* It was suggested below by Mr. HUGHES that the tax in question was not an income tax, but was a special excise tax, measured by the net income, as defined in §§244, 245; and he cited in support of his contention *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, and *Stratton's Independence* v. *Howbert*, 231 U. S. 399. It is sufficient to observe that the reference in the *Baltic Mining Co.* case to *Stratton's Independence* was *dictum*, and illustrative only; that *Stone Tracy* and *Stratton's Independence* both arose under the 1909 Corporation Tax before any income tax had even been adopted; and that the *Baltic Mining Co.* case, which was under the 1913 Income Tax case, was disposed of on the same grounds as *Brushaber* v. *Union Pacific*, 240 U. S. 1, and presented no question of tax-exempt income.

The Corporation Tax Act of 1909 levied a "*special excise tax* with respect to carrying on or doing business" equivalent to 1% upon the entire net income; and it was sustained because it was in no sense an income tax but only an excise tax. But after the adoption of the Sixteenth Amend-

ment, the income taxes, imposed by the Acts of 1913, 1916, 1917, 1918, and 1921 are very different in language, are in no sense excise taxes, but are expressly declared to be "income taxes." The pertinent provisions are collated in the margin.*

It is thus seen that all of these Acts, in practically the same language, impose specifically a tax upon the company's "entire net income," or "total net income" or "net income." There is not the slightest pretense that any of these Acts impose an excise tax for the privilege of conducting the life insurance business, but the taxes were specifically income taxes.

The Statute cannot be saved by endeavoring to call it something entirely different from what it aptly calls itself, and from what it, in fact, is, namely: an income tax, pure and simple. *Choctaw & Gulf R. R.* v. *Harrison*, 235 U. S. 292, 298; *Northwestern Ins. Co.* v. *Wisconsin*, 275 U. S. 136, 140.

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*The Act of 1913 levied a tax "upon the entire net income arising or accruing from all sources * * * to * * * every insurance company." 38 Stat. 172.

The Act of 1916 levied "upon the total net income received in the preceding calendar year from all sources by every * * * insurance company * * * a tax of two per centum upon such income." 39 Stat. 765.

The Act of 1917 levied "upon the total net income received in the preceding calendar year from all sources by every * * * insurance company * * * a tax of two per centum upon such income." 40 Stat. 333.

The Act of 1918 levied a tax "upon the net income of every corporation." 40 Stat. 1075-6.

The Act of 1921 imposed a tax "upon the net income of every life insurance company." 42 Stat. 261.

CONCLUSION.

The foregoing argument has established that §245(a)(2) taxes the income from tax-free securities; and unless all substance is to be sacrificed to mere form, the tax against the National Life was invalid.

If form is to prevail over substance, many of this Court's constitutional decisions protecting citizens from unlawful taxation by the States, or by Congress, can be nullified by a mere change in the form of the statute, so as to adopt the device of §245(a)(2).

The judgment should be reversed; and a judgment directed in favor of the National Life against the United States for $92,495.29, with interest.

GEORGE B. YOUNG,

[redacted]

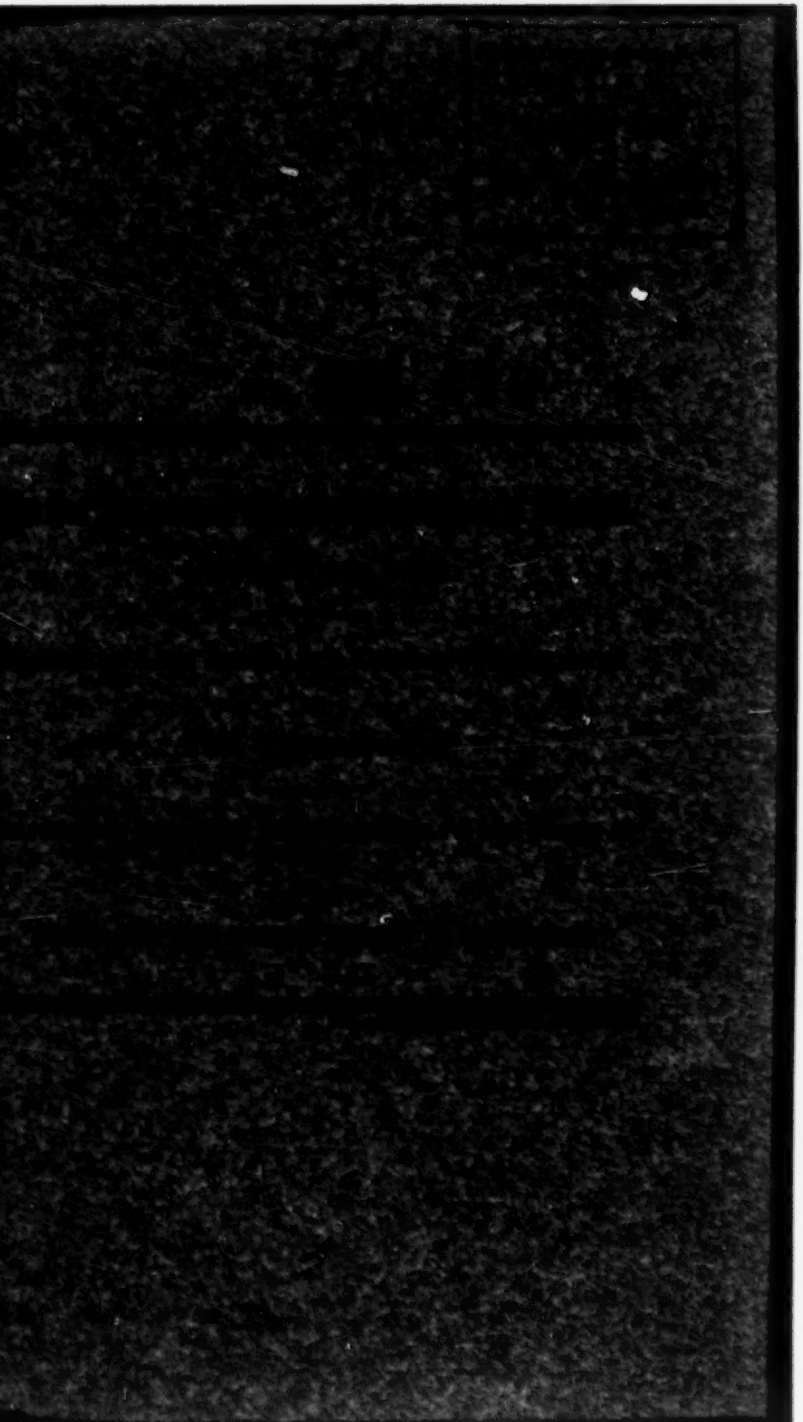
J. HARRY COVINGTON.

WM. MARSHALL BULLITT,

Counsel for Petitioner.

LOUISVILLE, KY.,
4 April, 1928.

BRIEF FOR THE UNITED STATES



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In the Supreme Court of the United States

OCTOBER TERM, 1926

No. 1077

NATIONAL LIFE INSURANCE COMPANY, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (R. 17) has not yet been officially reported.

JURISDICTION

The judgment of the Court of Claims was entered March 7, 1927. (R. 25.) The petition for certiorari was filed April 23, 1927. Jurisdiction to issue the writ is conferred by Section 3 (b) of the Act of February 13, 1925.

STATEMENT

This action was brought to recover income taxes alleged to have been illegally assessed under the provisions of Sections 243 to 245 of the Revenue Act of 1921, Act of November 23, 1921, c. 136, 42 Stat. 227, 261.

The facts are simple. Under the provisions of the statute, hereafter quoted, the only items of "gross income" of life insurance companies to be considered are interest, dividends, and rents. During the calendar year 1921 petitioner received in interest $3,811,132.78, in rents $13,460, and in dividends nothing. Its gross income, therefore, was $3,824,592.78. (Finding VII, R. 15.)

To find its net taxable income it was entitled to deduct—

(a) Interest from "tax exempt" securities amounting to $1,125,788.26, of which $873,075.66 was interest upon obligations of States and political subdivisions thereof, and $252,712.60 was interest upon obligations of the United States. (Finding V, R. 15.)

(b) The excess of 4% of the mean of its legal reserve for the year over the "tax exempt" interest. The mean of its reserve funds, held at the beginning and end of the year, was $67,381,977.92, 4% of which is $2,695,279.12. (Finding V, R. 15.)

(c) Miscellaneous deductions amounting to $294,411.67. (Finding VI, R. 15.)

Its net taxable income, therefore, was $924,901.99, upon which the tax at 10 per cent was $92,490.20. These figures were properly set forth in an amended return as follows (R. 14):

GROSS INCOME

Items		
1.	Interest from all sources (including tax exempts)	$3,811,132.78
2.	Dividends on stock of domestic and foreign corporations	
3.	Rents	13,460.00
4	Total items 1 to 3	3,824,592.78

DEDUCTIONS

5.	Interest exempt from taxation	$1,125,788.28	
6.	Excess of 4% of the mean of the reserve funds over item 5	1,569,430.86	
8 to 13.	Miscellaneous deductions	204,411.67	
14	Total of items 5 to 13		2,899,630.79
15	Net income		924,901.99
	Total tax		92,490.20

There is no dispute about the figures. The plaintiff's claim is that in place of Item 6, "Excess of 4% of the mean of the reserve funds over item 5," it was entitled to deduct the entire 4% of the mean of its reserve, not because the statute so provides, but because refusal to permit it to do so makes the Act unconstitutional. Accordingly, in the return which the Commissioner refused to accept, it stated its income as follows, reaching the result that it had suffered a loss and so was not taxable (R. 13, 14):

GROSS INCOME

Items		
1.	Interest from all sources (including tax exempts)	$3,811,132.78
2.	Dividends on stock of domestic and foreign corporations	
3.	Rents	13,460.00
4	Total items 1 to 3	3,824,592.78

DEDUCTIONS

5.	Interest exempt from taxation	$1,125,788.26	
6.	4% of the mean of the reserve funds	2,636,279.12	
8 to 13.	Miscellaneous deductions	264,411.67	
14.	Total of items 5 to 13		$4,025,479.05
15.	Net loss		280,886.27

THE STATUTE

The tax under Sections 243 to 245 of the Revenue Act of 1921, relating to life insurance companies, was a departure from the method formerly employed and was specially designed to meet the situation of companies of this class. Under prior Acts these companies were required to return their total income, including that derived from premiums paid by policy holders, and were allowed deductions which included expenses, policy losses, and net additions to legal reserve. It became evident that this method did not deal fairly with the peculiar business of insurance companies. It produced great difficulty in administration and resulted in much litigation. See *McCoach* v. *Insurance Company of North America*, 244 U. S. 585; *Maryland Casualty Company* v. *United States*, 251 U. S. 342; *United States* v. *Boston Insurance Company*, 269 U. S. 197; *New York Life Insurance Company* v. *Edwards*, 271 U. S. 109; *Duffy* v. *Mutual Benefit Life Insurance Company*, 272 U. S. 613.

The Revenue Act of 1921 sought to change the entire scheme, and, in lieu of all other taxes, to tax the life insurance companies on the basis of their

investment income from interest, dividends, and rents, with suitable deductions for expenses fairly chargeable against such investment income. (House Report No. 350, 67th Congress, 1st Session, H. R. 8245.) In the court below a brief was filed in behalf of several of the large life insurance companies as *amici curiae* in support of the Government's position, and in that brief it was stated:

> The method of taxing life insurance companies which is here brought into question, was carefully arranged after consultation with the representatives of leading insurance companies in order to provide a reasonable and fair basis of taxation and to avoid the difficulties which had grown out of the application of earlier statutes. This method is believed by the insurance companies, on whose behalf this brief is submitted, to be a fair one, and this belief, it is thought, is generally shared. It is for this reason that we support the contention of the Government in this case.

With this explanation we set forth the applicable sections of the statute as follows:

> TITLE II, PART III, TAXES ON INSURANCE COMPANIES (42 STAT. 261)
>
> SEC. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230 * * *.

* * * * *

SEC. 244. (a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, * * *.

Then follow other permitted deductions numbered (3), (4), (5), (6), (7), (8), and (9).

Subdivision (b) of Section 213 of the Act enumerates various classes of income which are exempt from taxation. Paragraph (4) of this subdivision (42 Stat. 238) is as follows:

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the

Federal Farm Loan Act of July 17, 1916; or (e) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes.

ARGUMENT

I

E RETURN WHICH THE PETITIONER WAS REQUIRED TO MAKE AND THE TAX THEREON ASSESSED WERE EXACTLY IN ACCORDANCE WITH THE STATUTE

This is too plain to require argument. Indeed, claim is made that the statute has not been followed. Petitioner's grievance is against the law elf, not against the way it has been construed.

II

TITIONER HAS NOT BEEN TAXED UPON ANY PART OF ITS INCOME FROM THE UNITED STATES, STATE, OR MUNICIPAL SECURITIES, AND THE LAW DOES NOT IMPOSE ANY TAX THEREON

Section 245 permits a deduction of all interest ceived from what are commonly called "tax-empt" securities, which are set forth in subdivi-

sion (b), paragraph 4, of Section 213 of the Act. No ingenuity or distortion can make it otherwise. If the gross income of a life insurance company consisted wholly of interest from such securities, it would all be deducted. The exemption is absolute and unqualified. Inasmuch as petitioner's entire argument is based upon a premise which has no existence, there is no necessity for attempting to follow the devious lines of the argument which has been built upon it. The underlying misconception is the theory that for some unexplained reason a life insurance company is entitled as of right to the further deduction of 4 per cent of its reserve. Such claim, however, is so devoid of substance that the mere statement of it carries its own refutation. Of course, Congress has not gone as far as it could in taxing the income of these companies. It has limited the items to be considered to three and has then given complete exemption to such portion of that income, no matter how large, as is derived from tax-exempt securities. It need not have gone further. It did, however, provide for a further deduction of 4 per cent of the reserve less the interest income already deducted once. If the interest received from tax-exempt securities and deducted equals or exceeds 4 per cent of the reserve, no further deduction is allowed. If 4 per cent of the reserve exceeds the tax-exempt income, the difference is allowed as an additional deduction. If a company has no tax-exempt securities, it is

allowed the entire 4 per cent deduction. What this further deduction, if any, will be depends, of course, upon the relation between the amount of the reserve, the amount of the income, and the proportionate investment in exempt and nonexempt securities. It is useless to speculate and exercise one's ingenuity in devising combinations of figures to produce seemingly inconsistent results, for no such speculation and no such hypothesis can alter the fact that under all circumstances every dollar of income from tax-exempt securities is deductible and the net taxable income cannot exceed what remains after that deduction has been made.

In petitioner's brief, page 5, there is a quotation from the testimony given by Dr. Adams before the Senate Committee on Finance, from which is drawn the inference that there was a deliberate attempt made to nullify the provision for the deduction of tax-exempt income. Later in his testimony, however, he made an explanation which gives quite a different color. He said:

> Under subdivision 2, by indirection, you give them the same deduction again. That is the main body of the deduction. If you take 4 per cent of the reserves required by law, which includes their tax-exempt bonds which will be earning about 4 per cent a year, perhaps, then you ought to deduct that tax-exempt income from that, because you will be giving it to them twice, and the companies

acquiesced in it. (Hearings before Committee on Finance, United States Senate, 67th Cong., 1st Sess. on H. R. 8245 September 1 to October 1, 1921, p. 87.)

No complaint can fairly be made, because the statute does not permit petitioner to deduct the same income twice.

III

THE STATUTE IS NOT DISCRIMINATORY

The difference between the business of life insurance companies and other corporations is so well known that the right of Congress to place them in a class by themselves is plain. *Knowlton* v. *Moore*, 178 U. S. 41; *Flint* v. *Stone Tracy Company*, 220 U. S. 107; *Barclay & Company* v. *Edwards*, 267 U. S. 442.

No unjust discrimination results from the fact that under certain relations between the reserve, the income, and the proportionate distribution of investments a company having no tax-exempt securities will pay no greater tax than one having some securities of that kind. Exemption of one class of securities from taxation is not defeated by the exemption of others also. Congress might have exempted all interest from the tax; and if it had done so, it would have been frivolous to claim that State bonds were thereby discriminated against. The holder of a State bond has no constitutional right to have other bonds taxed.

The petitioner had no inherent right to the deduction of any amount based upon its reserves. Deductions are a matter of legislative discretion, and authority for all deductions must be found in the statutes. *New Creek Company* v. *Lederer*, 295 Fed. 433, 435; *People ex rel. Bijur* v. *Barker*, 155 N. Y. 330; *Smalley* v. *City of Burlington*, 63 Vt. 443.

It is clear that upon constitutional grounds no complaint could have been made by any company had Congress entirely omitted the deductions specified in Section 245(a)(2). The fact that an insurance company holding no tax-exempt securities is entitled to deduct the whole 4 per cent of the mean of its reserves, while the same deduction is denied to a company receiving tax-exempt interest, is not discriminatory in the legal sense. *Brushaber* v. *Union Pacific Railroad Company*, 240 U. S. 1, 25. In the latter case it was argued that the provision limiting the amount of interest paid, which might be deducted from the gross income of corporations for the purpose of fixing the taxable income, to interest on indebtedness not exceeding one-half of the sum of bonded indebtedness and paid-up capital stock was wanting in due process because discriminating between different classes of corporations and individuals, the corporations having paid-up capital stock and bonded indebtedness being entitled to the deduction, while corporations not having paid-

up capital stock and bonded indebtedness were denied the deduction.

Congress has authority to adjust its income taxes according to its discretion within the bounds of geographical uniformity, and courts have no authority to pass upon the propriety of its measures. The Revenue Act of 1921 treats all insurance corporations alike, and if in its application the tax in particular instances may seem to bear upon one corporation more than another, this is due to differences in their circumstances, not to any uncertainty or want of generality in the tax imposed. *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 393.

IV

CONCLUSION

This case presents no question of public importance. We are advised that there is but one case now pending in the courts involving the question presented in the instant case, and further that no cases are pending decision before the Bureau of Internal Revenue.

The Treasury Department has consistently followed the construction of the Revenue Act of 1921 applied in this case and that construction has not been questioned by other life insurance companies except as herein stated. The decision below is so clearly right that there would be no reason for re-

view by this Court if many such cases were pending. The granting of the petition is unnecessary, and it is respectfully submitted that it should be denied.

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MAY, 1927.

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In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 228

NATIONAL LIFE INSURANCE COMPANY, PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the Court of Claims (R. 17) is reported in 63 Ct. Cls. 256.

JURISDICTION

The judgment of the Court of Claims was entered March 7, 1927. (R. 25.) The petition for certiorari was filed April 23, 1927, and granted June 6, 1927. Jurisdiction to issue the writ was conferred by Section 3(b) of the Act of February 13, 1925.

THE QUESTION PRESENTED

The question presented is simple but difficult to state without some preliminary understanding of the facts. Instead of a tax upon life insurance companies based upon their entire income, as under

There is no dispute about the figures. The plaintiff claimed that in place of Item 6, "Excess of 4% of the mean of the reserve funds over item 5," it was entitled to deduct the entire 4% of the mean of its reserve, not because the statute so provides, but because refusal to permit it to do so makes the Act unconstitutional. Accordingly, in the return which the Commissioner refused to accept, it stated its income as follows, reaching the result that it had suffered a loss and so was not taxable (R. 13, 14):

GROSS INCOME

Items			
1	Interest from all sources (including tax exempts)		$3,811,132.78
2	Dividends on stock of domestic and foreign corporations		
3	Rents		13,460.00
4	Total items 1 to 3		3,824,592.78

DEDUCTIONS

5	Interest exempt from taxation	$1,125,788.20	
6	4% of the mean of the reserve funds	2,096,229.12	
8 to 13	Miscellaneous deductions	204,411.67	
14	Total of items 5 to 13		4,025,479.06
15	Net loss		200,886.28

THE STATUTE

The tax under Sections 243 to 245 of the Revenue Act of 1921, relating to life insurance companies, was a departure from the method formerly employed and was specially designed to meet the situation of companies of this class. Under prior Acts these companies were required to return their total income, including that derived from premiums paid by policyholders, and were allowed deductions which included expenses, policy losses,

and net additions to legal reserve. It became evident that this method did not deal fairly with the peculiar business of insurance companies. It produced great difficulty in administration and resulted in much litigation. See *McCoach* v. *Insurance Company of North America*, 244 U. S. 585; *Maryland Casualty Company* v. *United States*, 251 U. S. 342; *United States* v. *Boston Insurance Company*, 269 U. S. 197; *New York Life Insurance Company* v. *Edwards*, 271 U. S. 109; *Duffy* v. *Mutual Benefit Life Insurance Company*, 272 U. S. 613.

The Revenue Act of 1921 sought to change the entire scheme, and, in lieu of all other taxes, to tax the life insurance companies on the basis of their "investment income" only, with suitable deductions for expenses fairly chargeable against such investment income. (House Report No. 350, 67th Congress, 1st Session, H. R. 8245.) In the court below a brief was filed in behalf of several of the large life insurance companies as *amici curiae* in support of the Government's position, and in that brief it was stated:

> The method of taxing life-insurance companies which is here brought into question, was carefully arranged after consultation with the representatives of leading insurance companies in order to provide a reasonable and fair basis of taxation and to avoid the difficulties which had grown out of the application of earlier statutes. This method is believed by the insurance companies, on

whose behalf this brief is submitted, to be a fair one, and this belief, it is thought, is generally shared. It is for this reason that we support the contention of the Government in this case.

With this explanation we set forth the applicable sections of the statute as follows:

TITLE II, PART III, TAXES ON INSURANCE COMPANIES (42 STAT. 261)

SEC. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;

* * * * *

SEC. 244. (a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

Interest on Tax

> (2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, * * *.

Then follow other permitted deductions numbered (3), (4), (5), (6), (7), (8), and (9).

Subdivision (b) of Section 213 of the Act enumerates various classes of income which are exempt from taxation. Paragraph (4) of this subdivision (42 Stat. 238) is as follows:

> (4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes.

SUMMARY OF ARGUMENT

The tax was assessed in strict compliance with the statute. The statute does not impose, nor was

it drawn with intent to impose, a tax upon income derived from tax-exempt securities. No question of unlawful discrimination is presented.

ARGUMENT

I

THE RETURN WHICH THE PETITIONER WAS REQUIRED TO MAKE AND THE TAX ASSESSED THEREON WERE STRICTLY IN COMPLIANCE WITH THE STATUTE

This is too plain to require argument. The construction which the petitioner originally attempted to place upon the statute is shown by the return which it filed on June 11, 1922 (Finding III, R. 13), in which it deducted the interest from its tax-exempt securities and also 4 per cent of its reserve funds, the result being a net loss. This, of course, disregarded the plain terms of the statute. Petitioner's grievance now is against the law itself, not against the way it has been construed.

II

PETITIONER HAS NOT BEEN TAXED UPON ANY PART OF ITS INCOME FROM TAX EXEMPT SECURITIES AND THE LAW DOES NOT IMPOSE ANY TAX THEREON

Section 245 permits a deduction of all interest received from what are commonly called tax-exempt securities, which are enumerated in Subdivision (b), paragraph 4, of Section 213 of the Act. No ingenuity or distortion can make it otherwise. If the gross income of a life-insurance company, as defined by the statute, consisted wholly of interest

from such securities, it would all be deducted no matter how much it might be. The exemption is absolute and unqualified. The misconception underlying the petitioner's argument is that for some unexplained reason a life-insurance company is entitled as of right to a further deduction of 4 per cent of its legal reserve without reference to the amount of that reserve or of the securities in which it is invested. Such claim, however, is devoid of substance.

Of course, Congress has not gone as far as it might in taxing the income of these companies. It has limited the items to be considered to three, and has then given complete exemption to such portion of that income, no matter how much, as is derived from tax-exempt securities. It need not have gone further. It did, however, provide for a further deduction of such amount, if any, as was necessary to bring the total deduction up to 4 per cent of the reserve. If the interest received from tax-exempt securities equals or exceeds 4 per cent of the reserve, no further deduction is allowed. If 4 per cent of the reserve exceeds the tax-exempt income, the difference is allowed as an additional deduction. If a company has no tax-exempt securities it is allowed, of course, the entire 4 per cent deduction. This is purely arbitrary and does not depend upon the nature of the investments. What this further deduction, if any, will be depends, of course, upon the relation between the amount of the reserve, the amount of the income, and the propor-

tionate investment in exempt and nonexempt securities. It is useless to speculate and exercise one's ingenuity in devising combinations of figures to produce seemingly inconsistent results, for no such speculation and no such hypotheses can alter the fact that under all circumstances every dollar of income from tax-exempt securities is deductible and the net taxable income can not exceed what remains after that deduction has been made.

We do not believe that anyone would be so rash as to claim that there is an obligation upon Congress to impose a tax upon one form of security merely because it has no power to impose a tax upon securities of another kind; or that the exemption from taxation of property which it has power to tax is an unconstitutional discrimination against property which it has no power to tax. Conceding that Congress has no power to tax income from state and municipal bonds and has power to tax income from rents, stock dividends, railroad bonds, and mortgages, it is obvious that it could exempt income from any one or all of these forms of investment without thereby infringing upon the immunity of the state and municipal bonds from taxation. In other words, the immunity of one class of security from taxation does not impose upon Congress an obligation to tax all other forms of investment, but that, though expressed more plausibly, is what petitioner's argument really means. Though the income from petitioner's tax-exempt bonds is absolutely free from tax, the argument

eems to be that an unconstitutional discrimination s made because another company will pay in dollars and cents a tax no greater than petitioners, lthough that company's reserve may be invested wholly in securities the income from which is axable.

Petitioner states as the first point in its brief hat Section 245 (a) (2) "is unconstitutional in so ar as it reduces the 4 per cent of reserves exemption by the exact amount of the National Life's tax-exempt income; and this is so because its purpose nd effect are to tax the income from tax-exempt onds." This statement, however, is inexact in wo particulars—first, because paragraph 2, when roperly regarded, does not reduce any exemption ut rather increases the exemption contained in aragraph 1; and second, because the purpose and ffect of the Act is not to tax income from tax-exempt bonds.

There are two ways of looking at almost every tatute. One way is to assume that Congress had n ulterior purpose in passing it and intended by ngenuity in the use of language to bring about an mproper result. Starting with that assumption, it s a comparatively easy thing for an ingenious ind to pick flaws in an Act and by a process of estructive criticism tear the structure to pieces. uch is not the proper spirit in which to approach onsideration of an Act of Congress. It is our duty assume that Congress intended to do right, not rong; that its purpose was honorable, not dis-

honorable; that it acted thoughtfully and conscientiously, and that its object was to do justice between the Government and its citizens. In that spirit we should approach consideration of this Act.

It is undoubtedly true that Congress realized that the basis of taxation of life-insurance companies, which had been followed for many years, was unfair, unjust, and unsound in principle. This Court has considered a number of cases involving the income and excess-profits tax imposed by prior legislation, and the theory of mutual life insurance is well understood by the Court, as indeed it is a matter of common knowledge. The premiums paid by the policyholders, calculated according to accepted experience tables of mortality, are contributions which they make to a fund which, when invested at an assumed rate of return, will be sufficient as time goes by to pay the face of the policies as they mature. The premiums paid always include an amount over and above the theoretical amount necessary to mature the policies, which will take care of the expenses of conducting the business and which is technically known as "loading." Looked at in this way it is apparent that the amounts necessarily contributed by the policyholders to the common fund are no more income to the company than are deposits in a bank income to the bank. It is also matter of common knowledge that the resources of life-insurance companies represent enormous aggregations of wealth; that the companies are among the largest purchasers of high-

grade securities, and many of them own real estate of great value and loan huge sums of money upon bond and mortgage. The character of investments which they may make are, to a large extent, regulated by state laws, and in general their investments are confined to securities regarded as sound and conservative. Among these securities are the obligations issued by states and municipalities.

Indeed, it is safe to say that these companies are among the largest purchasers in the market for such securities. Aside from the strictly underwriting feature of their business, it is apparent that their financial activities involve business transactions of huge magnitude. Under these circumstances Congress was called upon to determine what system of taxation would be fair and just in lieu of the taxation which had been imposed by former Acts, and its conclusion was that the measure of the tax should be based upon what might fairly be termed the "business income" of the company rather than its underwriting income, and the statute which we are now considering was the result. In previous Acts, which included gross premiums as an element of income, a deduction was allowed for the net additions made to the reserve. In the present Act, which limited income to three items, Congress first allowed a deduction of interest received from tax-exempt securities. That was as far as it was under any obligation to go. It is matter of common knowledge that the resources of the companies which represent the reserves include

millions of dollars' worth of tax-exempt securities upon which the rate of return is comparatively low. In some companies it might of course be larger than in others. This would depend upon the policy adopted by the companies in reference to the laws of the states in which they were authorized to do business; but having provided for the deduction of all nontaxable interest, it was deemed proper to go a step further, and in case the nontaxable interest did not equal 4 per cent of the reserve, Congress decided that an additional deduction up to 4 per cent of the reserve should be allowed.

In reporting the Bill the Senate Committee on Finance said:

> Sections 242–246 provide a new plan for the taxation of life-insurance companies, substantially similar to the plan embodied in the revenue act of 1918 as first adopted by the Senate. The provisions of the present law applicable to life-insurance companies are imperfect and productive of constant litigation. The proposed plan would tax life-insurance companies on the basis of their investment income from interest, dividends, and rents, with suitable deductions for expenses fairly chargeable against such investment income. The new tax would take the place of the present income and excess-profits taxes for the year 1921, and life-insurance companies would share with other insurance companies in the repeal in the year 1922 of the capital stock tax and the

> taxes imposed by section 503. The new tax will yield a larger revenue than the taxes which it is proposed to replace. (Senate Report 275, 67th Cong., 1st Sess., p. 20.)

To the same effect was the report of the Committee on Ways and Means of the House. (House Report 350, 67th Cong., 1st Sess., p. 14.)

Neither the Bill upon its face nor what was said of it by the committees having it in charge justifies the accusation that Congress was attempting by subterfuge to override its constitutional limitations or to impose an unrighteous system of taxation upon these companies.

The argument of petitioner is built upon a remark made by Dr. T. S. Adams at a hearing before the Senate Committee on Finance, as though that was a matter of importance which would influence the Court to hold an Act of Congress to be unconstitutional.

Statutes are not lightly to be declared beyond the power of Congress to pass because of informal and loose language made by witnesses at committee hearings. "This Court, by an unbroken line of decisions from Chief Justice Marshall to the present day, has steadily adhered to the rule that every possible presumption is in favor of the validity of an act of Congress until overcome beyond rational doubt." *Adkins* v. *Children's Hospital*, 261 U. S. 525, 544. The ultimate judicial question in considering the constitutionality of an Act is not

whether the Court construes the Constitution as permitting the Act, but whether the Constitution permits the Court to disregard the Act. *Attorney General* v. *McGuinness*, 78 N. J. L. 346, 373.

Later in the hearing, however, Dr. Adams modified his original statement, as follows:

> Under subdivision 2, by indirection, you give them the same deduction again. That is the main body of the deduction. If you take 4 per cent of the reserves required by law, which includes their tax-exempt bonds which will be earning about 4 per cent a year, perhaps, then you ought to deduct that tax-exempt income from that, because you will be giving it to them twice, and the companies acquiesced in it. (Hearings before Committee on Finance, United States Senate, 67th Cong., 1st Sess., on H. R. 8245, September 1 to October 1, 1921, p. 87.)

No complaint may fairly be made because the statute does not permit petitioner to deduct the same income twice. From the same testimony of Dr. Adams it appears that the life insurance companies were in favor of these provisions of the Bill, indeed, that the Bill was their scheme. Why this particular company should take the contrary position is not apparent. The single fact of importance is that the tax-exempt income of the companies is given complete exemption from taxation under any and all circumstances.

The case which petitioner's brief states to be the most "pertinent" authority in support of its con-

tention is *Miller* v. *Milwaukee*, 272 U. S. 713. The distinction between that case and the case at bar is obvious. In that case only so much of a stockholder's dividends as corresponded to the income of the corporation from United States bonds was taxed, and this Court held that such result was intentional and deliberate for the purpose of taxing indirectly what the legislature could not tax directly. The Court said, at page 715:

> A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity when they are its obvious aim. In such a case the Court must consider the public welfare rather than the artifices contrived for private convenience and must look at the facts.

United States v. *Ritchie*, Fed. Cas. 16168, seems to have been decided as a matter of statutory construction.

In *People* v. *Commissioners*, 41 Howard's Practice 459, involving a New York statute imposing a personal property tax, it is plain that the statute as construed by the authorities levied a direct tax upon United States bonds.

The cases of *Evans* v. *Gore*, 253 U. S. 245, and *Miles* v. *Graham*, 268 U. S. 501, holding that the salary of a United States judge was not subject to the income tax, are obviously inapplicable. In

those cases it was apparent that the salaries were as matter of fact taxed. Petitioner in his brief admits that they "are not as directly in point" as some of its other cases.

The case of *City of Waco* v. *Amicable Life Insurance Company*, 230 S. W. 698, affirmed 248 S. W. 332, is not in point. The tax there involved a personal-property tax. The statute allowed a deduction of the reserve as a debt. The court held that obligations of the United States should have been deducted from the amount of the personal property and then the debt represented by the reserve should be deducted from the residue. Laying the tax on property and authorizing the deduction of the entire amount of the reserve as a debt, the statute necessarily imposed a tax upon the United States securities, unless they should be deducted from what was left after the deduction of the reserve. Otherwise, the result would be that a tax would actually be paid on property constitutionally exempt from taxation. The court furthermore referred to the fact that the taxing statute expressly provided that personal property of insurance companies should be valued as other property was valued for assessment, and pointed out by reference to other statutes that the taxpayer was not required to report the amount of United States bonds.

In *Motor Car Company* v. *City of Detroit*, 232 Mich. 245, the statute taxed credits, except such as

were tax exempt, and also allowed a deduction on account of debts, and only such proportion of its indebtedness as was represented by the ratio between taxable credits and total credits. This was, of course, a direct tax upon the nontaxable credits. The tax involved was a property tax, and as the Supreme Court of Michigan said in the extract from its opinion quoted in brief for petitioner, "cases involving franchise, inheritance and succession tax have no application. Tax-exempt credits can not be taxed, directly or indirectly. In laying a tax on property, tax-exempt credits must be treated as nonexistent."

In *People* v. *Weaver*, 100 U. S. 539, involving a New York statute taxing personalty, the ground of the Court's decision was that the statute was void because it did not allow the same deduction for debts for a holder of national bank stock that it allowed for a holder of other moneyed capital.

The other cases cited do not seem to require discussion.

III

THE STATUTE IS NOT DISCRIMINATORY

The tax upon life insurance companies is in reality a special excise tax designed to meet the peculiar facts involved in the business of these companies. The difference between the business of life insurance companies and other corporations is now so well understood that the right of Congress to place them in a class by themselves is plain. *Knowl-*

ton v. *Moore*, 178 U. S. 41; *Flint* v. *Stone Tracy Company*, 220 U. S. 107; *Barclay & Company* v. *Edwards*, 267 U. S. 442.

No unjust discrimination results from the fact that under certain relations between the reserve, the income, and the proportionate distribution of investments, a company having no tax-exempt securities will pay no greater tax than one having securities of that kind. Exemption of one class of securities from taxation does not require the taxation of others. Congress might have exempted from the tax all interest, and if it had done so, it would have been frivolous to claim that state bonds were thereby discriminated against. The holder of tax-exempt securities has no constitutional right to have other securities taxed.

Petitioner had no inherent right to the deduction of any amount based upon its reserves. Deductions are a matter of legislative discretion and authority for all deductions must be found in the statute. *New Creek Company* v. *Lederer*, 295 Fed. 433, 435; *People ex rel Bijur* v. *Barker*, 155 N. Y. 330; *Smalley* v. *City of Burlington*, 63 Vt. 443.

It is clear that upon constitutional grounds no complaint could have been made by any company had Congress omitted entirely the deductions specified in Section 245 (a) (2). The fact that an insurance company holding no tax-exempt securities will under certain circumstances pay no greater tax than will another company having tax-exempt securities, is not discriminatory in a legal sense. Com-

pare *Brushaber* v. *Union Pacific Railroad Company*, 240 U. S. 1, 25. It is not discrimination against tax-exempt securities to give exemption to other securities which could lawfully be taxed, and no corporation holding securities which may not constitutionally be taxed has a right to insist that its neighbor, owning securities which are within the taxing power, shall be taxed. The uniformity required by Article I, Section 8, Clause 1 of the Constitution means geographical uniformity. *Knowlton* v. *Moore*, 178 U. S. 41; *Patton* v. *Brady*, 184 U. S. 608; *Barclay & Co.* v. *Edwards*, 267 U. S. 442, 450.

Congress has authority to adjust its income taxes according to its discretion within the bounds of geographical uniformity. The Revenue Act of 1921 treats all insurance corporations alike, and if in its application a tax in particular instances may seem to bear upon one corporation more than another, this is due to differences in their circumstances, not to lack of uniformity in the tax imposed. *LaBelle Iron Works* v. *United States*, 256 U. S. 377.

Petitioner's whole contention is summarized as follows, on pages 59 and 60 of its brief:

> The whole point is that the ownership of tax-exempt securities, can not be made the basis of a classification, whose sole purpose is to tax more heavily those who hold tax-exempt securities, than those who do not hold them.

> The Government can tax anything it pleases, except tax exempts; but it must deduct tax exempts from anything on which it imposes taxes. It can give any further deductions that it pleases, and it can ascertain what that deduction shall be in almost any way it pleases.

This summary contains the complete refutation of its own argument. No company under this statute can possibly be taxed by reason of its ownership of tax-exempt securities more heavily than those which do not hold them, other things being equal, and "tax-exempt securities" are under all conditions deducted from that upon which the taxes are imposed.

CONCLUSION

The judgment should be affirmed.

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